

91-512

Supreme Court, U.S.

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No. _____

In The
Supreme Court of the United States

October Term, 1991

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Respondents.

Petition For A Writ Of Certiorari To The
United States Court Of Appeals
For The Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Is the Court of Appeals' interpretation of Maryland law to require a futile demand upon directors in a derivative action under the Investment Company Act inconsistent with the federal policy underlying the proxy fraud provisions of that Act which the derivative action seeks to enforce?

2. Is the Court of Appeals' interpretation of Maryland law erroneous?

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OPINIONS BELOW

The February 2, 1987 opinion of the District Court for the Northern District of Illinois is reported at 659 F. Supp. 1153. The July 18, 1990 opinion of the Court of Appeals for the Seventh Circuit is reported at 908 F.2d 1338. Upon remand from this Court's decision of May 20, 1991 (111 S. Ct. 1711), the Court of Appeals rendered a decision which is reported at [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,183.

JURISDICTION

The decision of the Court of Appeals for the Seventh Circuit was dated and filed on August 7, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Due to their length, Article VI of the Constitution, Section 20(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-20(a), Section 44 of the Act, 15 U.S.C. § 80a-43, SEC Rules 20a-1 and 20a-2(b)(4), 17 CFR §§ 270.20a-1 and 270.20a2(b)(4), and Rule 23.1 of the Federal Rules of Civil Procedure are set forth in the appendix at App. 107-10.

STATEMENT OF THE CASE

Petitioner is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund"), an open-end investment company or mutual fund registered under the Investment Company Act of 1940. She has brought the action on behalf of the Fund against Kemper Financial Services, Inc., its investment adviser (the "Adviser"). This petition seeks review of the Seventh Circuit's decision following a reversal and remand by this Court.

The action is brought under Sections 20(a) and 36(b) of the Investment Company Act. (Jurisdiction is based upon Section 36(b), 15 U.S.C. § 80a-35(b), and upon Section 44 of the Act, 15 U.S.C. § 80a-43.) Section 20(a) proscribes the fraudulent solicitation of proxies with respect to a registered investment company. The complaint herein alleges that the defendant distributed a false and misleading proxy statement which misrepresented comparative fee rates in order to obtain shareholder approval of its agreement with the Fund. The plaintiff complains that the Adviser provides substantially the same services for a sister fund and charges the sister fund significantly less, whereas the proxy statement gives the false impression that the fee rates paid by the sister fund are as high or higher than those paid by the Fund. App. 101-03. The complaint seeks the payment of damages to the Fund resulting from the fraud. App. 105.

Section 36(b), which mandates a fiduciary duty with respect to the receipt of compensation, is not implicated in the instant proceeding.

Plaintiff made no pre-suit demand upon the directors to institute or prosecute the action. The complaint sets

forth the reasons for not making such a demand. Those reasons are as follows:

(a) With respect to the claims asserted under Section 36(b) of the Act, no such demand is required.

(b) The "interested" directors have a personal financial interest adverse to the successful prosecution of the lawsuit, and the so-called "non-interested" directors are beholden to the Adviser; they receive aggregate remuneration of approximately \$300,000 a year as directors of the Fund and other Funds managed by the Adviser.

(c) All of the directors voted to distribute the false proxy statement so that any suit brought to establish liability for the falsity of the statement would establish their own culpability and liability.

(d) The directors caused the Fund to oppose the action on substantive grounds.

In addition, the complaint alleges that the directors are under the control of the Adviser and that application of a demand requirement would be inconsistent with the federal policy underlying Section 20 of the Investment Company Act. App. 104-05. In deposition testimony, the directors testified that they would not institute this action. App. 7-8. In short, as alleged in the complaint, making a demand on the Fund or its directors to institute or prosecute this action would be futile.

Defendants moved to dismiss plaintiff's claim of proxy fraud, and the District Court granted the motion on the ground that plaintiff had failed to justify the absence of demand upon the Fund directors to institute suit to

recover for that claim. App. 92. Thereafter, the District Court dismissed the Section 36(b) claim, giving rise to a final judgment. App. 96.

Upon appeal, the Court of Appeals reinstated the Section 36(b) claim, but affirmed the dismissal of the proxy fraud claim, holding that demand on directors must be made even if it be futile. Upon certiorari, this Court reversed the holding of the Court of Appeals. This Court held that the Court of Appeals erred in imposing a universal demand requirement. This Court re-emphasized that federal courts should apply state law unless that law is inconsistent with the policies underlying the federal statute. App. 18-20, 32. Thus, the Court of Appeals should have looked to the law of the state of incorporation, Maryland, without "replacing 'the entire corpus of state corporation law' relating to demand futility." App. 29. This Court held that "a futility exception to demand does not impede the regulatory objectives" of the Investment Company Act, and remanded the case to the Court of Appeals to determine whether petitioner adequately pleaded excuse of demand for purposes of Rule 23.1 of the Federal Rules of Civil Procedure. App. 32.

On remand, the Court of Appeals found that only one Maryland case discussed the futility exception and stated that that case did not dispose of the issue one way or another. App. 3, 4. The Court of Appeals acknowledged that decisions in other states supported petitioner's argument that the directors' participation in the questioned acts excuses demand; but, relying upon the same non-judicial authority utilized in its earlier opinion, the Court stated that the tide is running in the opposite

direction and that Maryland could well be influenced by the recommendations contained in ALI and ABA tentative drafts. App. 5-7. Once again the Court made clear that its reasoning was influenced by its doubt of the value of derivative litigation. App. 7. Distorting this Court's carefully articulated reasoning in the case, the Court of Appeals refused to consider whether its interpretation of Maryland law ran afoul of the federal anti-proxy fraud policy established by the Investment Company Act. App. 3. The Court of Appeals thus again affirmed the dismissal of the derivative claim under Section 20 of the Act.

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals' Decision Conflicts With Applicable Decisions of This Court.

It has long been recognized that federal law will displace state laws if "their application would be inconsistent with the federal policy underlying the cause of action." *Johnson v. Railway Express Agency, Inc.*, 421 U.S. 454, 465 (1975). Citing a long line of cases, this Court held in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979):

Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. If so, we must fashion special rules solicitous of those federal interests.
[Footnote omitted]

Similarly, in *Burks v. Lasker*, 441 U.S. 471, 479 (1979), this Court, specifically referring to the Investment Company Act, noted that state laws governing the powers of directors would apply unless their application would be inconsistent with the federal policy underlying the cause of action. Relying upon *Sola Electric Co. v. Jefferson Electric Co.*, 317 U.S. 173 (1942), the Court held (441 U.S. at 479 n.6):

. . . The real concern, therefore, is not that state laws be uniform, but rather that the laws applied in suits brought to enforce federal rights meet the standards necessary to insure that the "prohibition of [the] federal statute . . . not be set at naught," . . .

In the instant case, this Court reaffirmed this important principle. The Adviser contended that the futility exception to the demand requirement somehow impeded the regulatory objectives of the Investment Company Act. This Court disagreed. It discerned that the Act clearly envisions an *enhanced* role for shareholders in protecting investment companies from conflicts of interest. App. 31. "Under these circumstances, it can hardly be maintained that a shareholder's exercise of his state-created prerogative to initiate a derivative suit without the consent of the directors frustrates the broader policy objectives of the ICA." *Id.*

In a play of intellectual legerdemain, the Court of Appeals twisted this Court's holding that the futility exception is not inconsistent with the ICA. The Court below interpreted that holding as being a holding that no federal rule prevents the application of Maryland law. App. 3. It then went on to hold (erroneously, as we show

below, pp. 9-16) that Maryland would require a demand in the facts of the instant case. It gave no consideration to the frustration of federal policies resulting from its holding.

In *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980), a case subsequent to *Burks v. Lasker*, the Court of Appeals for the Second Circuit, relying upon this Court's seminal decision in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), held that claims under the proxy laws were not subject to dismissal under the business judgment rule. Referring to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), the Court concluded (615 F.2d at 64):

In short, we conclude that to the extent that a complaint states claims against directors under § 14(a) upon which relief may be granted, federal policy prevents the summary dismissal of those claims pursuant to the business judgment of those defendant directors.

The conclusion that well pleaded § 14(a) claims against directors are not subject to summary dismissal on the basis of their exercise of business judgment makes unnecessary further study of what powers Ohio law would grant with respect to the § 14(a) claims.

Galef relied upon the strong public policy declarations in *Borak* ("Private enforcement of the proxy rules provides a necessary supplement to Commission action. [377 U.S. at 432]¹ . . . the overriding federal law applicable here would, where the facts required, control the

¹ This policy was expressly and strongly reaffirmed in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

appropriateness of redress despite the provisions of state corporation law . . . " 377 U.S. at 434).

The priority of the strong public policy embodied in the federal proxy laws was pointed out by the SEC when this case was here earlier:

A proxy claim asserts a violation of a shareholder's own right to truthful and complete information in communications used to solicit his vote. Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n (a) – the original provision in the securities laws regulating the solicitation of proxies – was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which [had] frustrated the free exercise of the voting rights of stockholders." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934). The provision's purpose is to guarantee that persons soliciting proxies will provide "an explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934). See *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970). In 1940, Congress likewise empowered the SEC to prescribe proxy-solicitation rules for investment companies "as necessary or appropriate in the public interest or *for the protection of investors*." 15 U.S.C. 80a-20(a) (emphasis added). See S. Rep. No. 1775, 76th Cong., 3d Sess. 17 (1940).

* * *

It would be deeply ironic if directors could secure the shareholders' votes through a misleading proxy statement, and then insist that a shareholder seeking redress make demand on the directors before suing.

Brief for the Securities and Exchange Commission as Amicus Curiae at 10-11, *Kamen v. Kemper Financial Services, Inc.*, 111 S.Ct. 1711 (1991).

The Court of Appeals' decision ignored these important principles enunciated by this Court. Its holding results in the frustration of the federal policies embodied in Section 20 of the Act.

II. The Court of Appeals' Decision Is In Conflict With the Highest Court of Maryland.

According to the Court of Appeals, only one Maryland case discusses the scope of the futility exception. That case is *Parish v. Maryland & Virginia Milk Producers Assoc.*, 250 Md. 24, 242 A.2d 512 (1968), *cert denied*, 404 U.S. 940 (1971). Although not standing alone, *Parish* is indeed the leading Maryland case.

Although the description of the complaint in *Parish* is quite lengthy, the nature of the action can be summarized somewhat more pithily. The plaintiffs were members of a milk producers farm cooperative association, which was treated by the Maryland Court of Appeals (that state's highest court) as a corporation and the plaintiffs as shareholders. Two types of wrongs were charged in the complaint.

The first was the purchase by the association of the Embassy Dairy in violation of the antitrust laws and the subsequent necessitated sale of that dairy at a loss, the existence of which was cloaked by an annual report which made no mention of a subsequent discount which resulted in converting an apparent profit into a loss. The directors were accused of gross negligence and culpable mismanagement. However, none of the directors was alleged to have had a financial interest in the transaction; rather, they "are deemed to have assented" thereto (242 A.2d at 524) and as directors "are deemed responsible" for the failure of the annual report to fully describe the discount transaction (242 A.2d at 527).

The other type of wrong consisted of a series of transactions whereby two officers of the association, neither of whom was a director, diverted corporate assets to themselves. Here also, none of the directors participated financially. Indeed, the board, although reluctant to provide information to the plaintiffs (242 A.2d at 535-36), caused an independent investigation to be made, fired the offending officers, and managed to recoup a small portion of the amounts diverted (242 A.2d at 531-34). It was alleged that the two officers were in actual control of the operation of the association and that the board relied upon them, trusted them and were guided by them in regard to the association's affairs (242 A.2d at 557).

The plaintiffs were unable to specify which directors "voted in favor of or otherwise assumed responsibility for the particular wrongful acts of which they complain" (242 A.2d at 523), nor could they name any directors who supported the derelict officers or condoned their wrongdoing (242 A.2d at 534-35).

The Maryland Court held that the complaint alleged sufficient grounds to excuse the plaintiffs from exhausting their intra-corporate remedies before instituting suit because a prior demand would have been futile (242 A.2d at 544). The complaint, held the Court, stated causes of action against the directors and alleged that a majority of the Board participated in various of the alleged acts, thus making it futile for the plaintiffs to make demand upon the directors (242 A.2d at 545).

The Court below held that Parish adversely disposed of a number of petitioner's contentions. The Court of Appeals characterized two of these contentions as follows: "Kamen observes that the directors receive fees for their services and alleges generally that the directors are under Kemper's thumb." App. 4. The allegations to which the Court of Appeals refers are as follows:

"(b) The board of directors of the Fund consists of ten members. Of those, three are 'interested' as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called 'non-interested' directors currently receive aggregate remuneration of approximately \$300,000 a year for serving as directors of the Fund and of all of the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;"

"(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;" (App. 104, 105)

This is hardly a case, therefore, of directors simply receiving fees. The Adviser selects the same persons to serve, not just as directors of the Fund, but as directors of all the Funds which it manages. The aggregate compensation received as serving in the directorial capacity is thus easily large enough to properly characterize the directors as sufficiently "self-interested" to justify dispensing with demand as futile. See *Ohman v. Kahn*, 685 F. Supp. 1302, 1307 (S.D.N.Y. 1988). There is nothing in *Parish* to indicate otherwise. There the complaint presumed "undue pressure and influence" from condonation of the allegedly wrongful acts (242 A.2d at 534).

The Court of Appeals below believed that it was fatal to the plaintiff that the directors are not named as defendants. Although in the present case the directors are not themselves defendants, they are the ones who distributed the proxy statement and are, therefore, directly responsible for the violations. App. 104. As the complaint alleges, the action, if successful, would establish their culpability. Just as a plaintiff may not bootstrap his futility assertions by naming innocent directors as defendants, *Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983), by the same token, petitioner Kamen's choice not to name the directors in the first instance does not establish their impartiality. *Lewis v. Curtis*, 671 F.2d 779, 786-7 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).²

² Moreover, under *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 401 U.S. 321, 339 (1971), the Adviser might bring an action for indemnification or contribution against the directors if a judgment were recovered against it.

Indeed, not only did the directors disseminate the proxy statement, but they did so with knowing or reckless disregard of its falsity. Paragraph 13 of the Complaint alleges that the proxy statement "misleadingly described the fees" paid by a sister fund and "gave the false impression that the fees paid" by the sister fund were as high or higher than the fees paid by the Fund. App. 102. The directors were also directors of the sister fund (App. 104) and thus knew that the fee structure was falsely represented. Accordingly, the Complaint asserts that any suit "brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund". ¶ 17(c), App. 104.

The statement by the Court below that "demand is necessary if the directors are . . . financially disinterested" in the transaction under attack (App. 6) is in direct conflict with *Parish* where the Maryland Court excused demand even though the directors had no financial interest in the challenged transactions.

The Court below rejected petitioner's invocation of *Parish* for the proposition that post-complaint opposition to the suit by the directors on the merits justifies the failure to make demand on the ground that *Parish's* pronouncement of that principle applied to demand on shareholders. The Court below sought to distinguish demand on directors from demand on shareholders on the ground that the latter generally lack complete information and are widely dispersed, and that only unanimous action of the shareholders can ratify corporate waste. However, none of those factors played a part in *Parish*. The Maryland Court in *Parish* based its finding of

futility on the fact that after the lawsuit was commenced, the shareholders adopted a resolution expressing their opposition to the lawsuit (242 A.2d at 545-46).

In the present case, the directors not only caused an answer to be filed asking for dismissal of the suit on the merits, but also testified on deposition that they were opposed to the plaintiff's contentions.³ Since in Maryland opposition in fact "indicates the futility of requiring a prior demand" (242 A.2d at 546), there is no reason to believe that that state would treat directorial opposition differently. This is borne out by *Booth v. Robinson*, 55 Md. 419 (1881), relied upon by the court below, where the alleged wrongdoers constituted only two of the six members of the board of directors. The court there held that opposition in fact by a majority of the directors was a sufficient excuse for not making or alleging a formal demand; 55 Md. at 439. In holding that substantive opposition to the plaintiff's claims excuses demand, Maryland hardly "blaze[s] a lonely path" (App. 9). The Seventh Circuit itself has so held; *Nussbacher v. Continental Illinois National Bank*, 518 F.2d 873, 878-9 (7th Cir. 1975), cert. denied, 424 U.S. 928 (1976). So, too, has this Court; *Smith v. Sperling*, 354 U.S. 91, 96-97 (1957).

Finally, the Court below, as it had done earlier, imported its "doubt[s] on the value of derivative litigation for investors" (App. 7) to speculate that Maryland might either abolish the futility exception or make more stringent its demand requirements (*Id.*). The Court would

³ The Board was advised by supposedly independent counsel Charles F. Custer, who was, however, an interested person of the Adviser.

have done well to look to the *Parish* case in attempting to ascertain the trend in Maryland. In *Parish*, the Maryland Court of Appeals held (242 A.2d at 546):

In considering this entire question, it should be kept in mind that the trend in the more modern authorities is to be more tolerant of the derivative suits of minority members or stockholders. The size and complexity of corporate transactions makes necessary and important this form of "legal therapeutics" to quote a phrase used by George D. Hornstein in his article entitled "Legal Therapeutics: The 'Salvage' Factor in Counsel Fee Awards," 69 Harv.L.Rev. 658 (1956). See also Hornstein, "The Counsel Fee in Stockholder's Derivative Suits," 39 Col.L.Rev. 784 (1939) and 39 A.L.R. 2d 580. The allegations of the complaint are, in our opinion, sufficient to excuse the plaintiffs from making a prior demand upon the Board and the general membership and from pursuing the remedy of mandamus against the Board.

Other federal courts have more accurately gauged the tenor of the Maryland Court of Appeals. See, for example, *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990), in which the Court held that the Maryland futility exception excuses demand even more readily than federal law; and *Rosengarten v. Buckley*, 565 F. Supp. 193, 197-8 (D. Md. 1982), which holds that under Maryland law, fraud, such as the proxy fraud involved here, vitiates the demand requirement. See also *Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984), citing *Eisler v. Eastern States Corp.*, 182 Md. 329, 333 (1943), and *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978). In the last cited case, the

Court, applying Maryland law, concluded (77 F.R.D. at 740):

Accordingly, given plaintiff's allegations that all of the trustees either actively participated in the wrongful transactions or, at the least, approved or ratified such transactions with knowledge or notice of their illegality, the court concludes that demand upon the trustees to bring this action should be excused.

. . . the conduct of the unaffiliated trustees in this action, which conclusively demonstrates their antagonism to it. ANRET's answer did not take a neutral position. Nor did ANRET merely oppose this action on the basis of lack of demand on the trustees or its shareholders. Rather, ANRET has vigorously opposed this action *on the merits*. In this regard, there is also authority that a demand upon directors or trustees is unnecessary where the derivative entity contests the action on the merits. *See, e.g., Meltzer v. Atlantic Research Corp.*, 330 F.2d 946, 948 (4th Cir.), *cert. denied sub nom., Scurlock v. Meltzer*, 379 U.S. 841, 85 S.Ct. 78, 13 L.Ed.2d 47 (1964).

CONCLUSION

The Court of Appeals has interpreted Maryland law in a way that conflicts with the enunciation of that law by the highest court of Maryland. The decision of the court below also conflicts with decisions of this Court in a way that undermines the proxy laws and is thus contrary to

Article VI of the Constitution. The petition for a writ of certiorari should be granted.

Dated: New York, New York
September 25, 1991

Respectfully submitted,

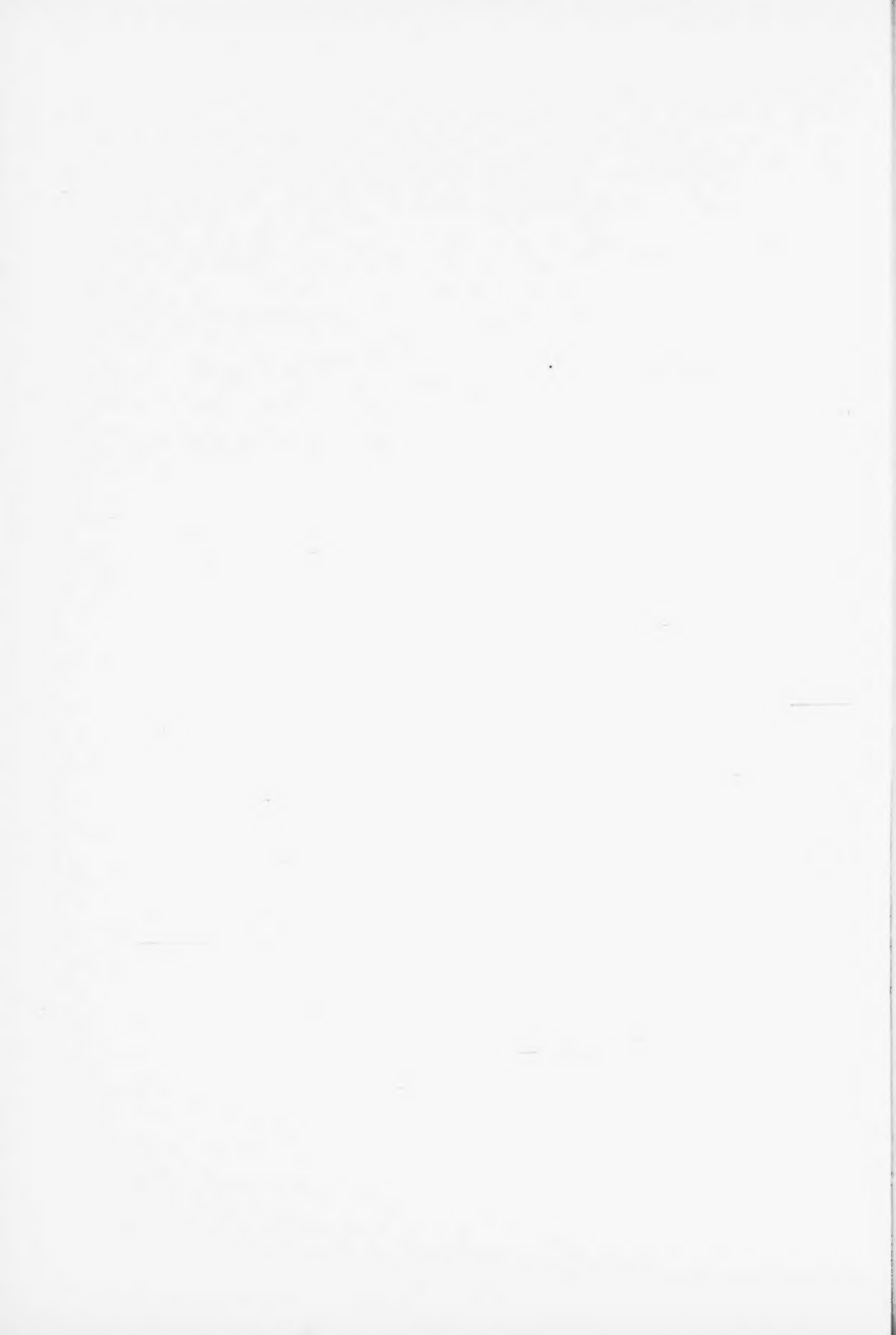
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APPENDIX

App. 1

Court of Appeals Decision dated August 7, 1991

**In the
United States Court of Appeals
For the Seventh Circuit**

No. 89-2967

JILL S. KAMEN,

Plaintiff-Appellant,

v.

KEMPER FINANCIAL SERVICES, INC.,
and CASH EQUIVALENT FUND,

Defendants-Appellees.

On Remand from the
Supreme Court of the United States.

SUBMITTED JULY 3, 1991 – DECIDED AUGUST 7, 1991

Before CUMMINGS, EASTERBROOK, and RIPPLE, *Circuit Judges.*

EASTERBROOK, *Circuit Judge.* The Supreme Court remanded this case with instructions to decide whether, under federal law reflecting the law of Maryland, Kamen has established adequate reason for not making a demand on the directors of the Cash Equivalent Fund. 111 S.Ct. 1711, 1722-23 & n.10 (1991). Kamen's request that we allow the district court to resolve that question in the first instance is inconsistent with both the Supreme Court's instructions and her argument to the Supreme

Court that we erred in declining to apply Maryland law. (We had declined, 908 F.2d 1338, 1342 (1990), because Kamen did not raise any question of Maryland law in the district court, or in this court until her reply brief – the very circumstance that Kamen now asserts makes a remand appropriate.) Moreover, the question is one of law, and little would be served by increasing the number of layers in this case, which has aged considerably without drawing close to trial.

Kamen maintains that the Fund violated her rights under federal law by circulating a proxy statement containing a misleading comparison between the investment fees charged to the Fund and the fees charged to other members of Kemper's group of funds. Rule 23.1 requires the plaintiff in a derivative suit to allege "with particularity . . . the reasons for the plaintiff's . . . not making the effort" to demand action from the directors. Kamen's complaint, as amended after the close of discovery, alleges six reasons for failure to make demand:

1. The seven independent directors on the ten-person board received "aggregate remuneration of approximately \$300,000 a year" for their role as directors of the Cash Equivalent Fund and other members of the Kemper Group.
2. The directors voted to circulate the proxy statement containing the statement to which Kamen objects.
3. A demand would have been tantamount to a request that the directors sue themselves.
4. The directors were "under the control" of Kemper.

App. 3

5. The Fund sought to dismiss her complaint on substantive as well as procedural grounds.
6. Federal "policy" established by the Investment Company Act of 1940 augurs against demand.

We dismiss reason six immediately in light of the Supreme Court's holding that no federal rule prevents the application of Maryland law. 111 S. Ct. at 1722. What remains for decision is whether Maryland treats any of the other five reasons as enough to allow derivative litigation without a demand on directors.

Like most states, Maryland both requires demand as a norm and excuses demand when the request would be futile. *Waller v. Waller*, 187 Md. 185, 191-92, 49 A.2d 449, 453 (1946); *Eisler v. Eastern State Corp.*, 182 Md. 329, 333, 35 A.2d 118, 119-20 (1943). Maryland has done little to develop the scope of its futility exception. Only one case in the state's history discusses that doctrine. *Parish v. Maryland & Virginia Milk Producers Association*, 250 Md. 24, 81-84, 242 A.2d 512, 544-45 (1968).

The plaintiff in *Parish* contended that a majority of the association's board had defrauded it. The suit named as defendants both the association and the members of its board. The court thought that it would be futile to ask the members of the board to sue themselves for wrongdoing and held that demand is excused when the alleged wrongdoers both are defendants and constitute a majority of the board. The Fund contends that *Parish* requires judgment in its favor because Kamen does not allege that the directors engaged in fraud and has not sued any of them; Kamen submits that *Parish* requires a decision in

her favor because all of the members of the Fund's board approved the proxy statement and thus took part in what she characterizes as wrongdoing.

Parish does not dispose of these arguments one way or another. It is a single point, and you can draw a line any which way through one point on a plane. *Parish* does, however, enable us to resolve several of Kamen's arguments. By reiterating that demand is the norm in Maryland, *Parish* shows that Kamen's first and fourth allegations are insufficient. Kamen observes that the directors receive fees for their services and alleges generally that the directors are under Kemper's thumb. If allegations of this kind sufficed, the demand rule would be negated – for almost all directors receive fees, and independent directors come to a board after being slated by corporate insiders. There would have been no need in *Parish* to inquire into the directors' personal culpability if their status as directors (together with payment for their time) were enough to dispense with demand. The "control" allegation also flunks the "particularity" requirement of Rule 23.1, which governs how the plaintiff must allege matters substantively material under state law. The complaint alleges no facts pertinent to control and so does not satisfy the "particularity" requirement even if "control" could be a sufficient excuse under Maryland law.

Parish is inconsistent with Kamen's third allegation too: that demand would be equivalent to a request that the directors sue themselves. Kamen wants relief against Kemper, which collected the allegedly excessive fees, not against the directors personally. As Kamen does not believe that the facts justify action against the directors

individually, demand would not have implied that the directors should go sue themselves. Maryland does not think it sufficient that something bad happened on a director's watch; it requires proof of wrongdoing. E.g., *Waller*, 187 Md. at 190-91, 49 A.2d at 452-53; *Booth v. Robinson*, 55 Md. 419 (1880). The business judgment rule protects the directors against personal liability for ordinary errors. So Kamen's reasons come down to two: that the directors approved the proxy statement, and that the directors have opposed her suit on the merits.

Whether the directors' involvement in the transaction complained of excuses demand depends on the function of the demand rule. If demand serves only to alert the directors to a grievance, then their involvement excuses demand because they already know what they have done. If however demand either recognizes the allocation of powers within the corporation (apportioning the initial decision to those the investors have handed the reins) or serves a screening role (a form of alternative dispute resolution helping to weed out weak cases), then the fact that the directors participated in the transaction is not enough. Maryland has not spoken clearly to the function demand serves; still, *Waller* treats demand as a useful screen for the courts, and *Parish* says that application must be made unless the directors are "wrongdoers". Participants who are not "wrongdoers" may evaluate their acts and change their minds.

Decisions in several states support Kamen's argument that the directors' participation in the questioned acts excuses demand. E.g., *Barr v. Wackman*, 36 N.Y.2d 371, 329 N.E.2d 180 (1975); *Valiquet v. First Federal Savings & Loan Association*, 87 Ill. App. 3d 195, 408 N.E.2d 921, 926

(1st Dist. 1979). The tide is running against this approach, however. See ALI, *Principles of Corporate Governance: Analysis and Recommendations* 76-81 (T.D. No. 8, 1988) (Reporter's note analyzing state cases). Delaware, today's dominant corporate jurisdiction, has emphatically rejected the proposition that an investor may forego demand whenever the directors participated in the transaction they challenge. *E.g.*, *Grobow v. Perot*, 539 A.2d 180 (Del. 1988); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). See also, *e.g.*, *Starrels v. First National Bank of Chicago*, 870 F.2d 1168, 1170-71 (7th Cir. 1989); *Lewis v. Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983), collecting authority to the same effect. The prevailing contemporary view is that demand is necessary if the directors are disinterested – and because of the business judgment rule directors may be financially disinterested even if they took part in the acts of which the plaintiff complains. Careless acts by directors are regrettable but not a source of personal liability. So a plaintiff who believes that the directors violated their duty of care may ask them to take remedial action without putting their fortunes at risk.

Aronson and comparable cases conclude that unless there is good reason to doubt that the directors' acts are protected by the business judgment rule, a disgruntled investor must ask the directors to act. Maryland has never addressed this issue. In resolving doubt about the scope of its demand requirement, Maryland could well be influenced by the recommendations of the American Law Institute and the American Bar Association, both of which believe that the futility exception to the demand requirement should be eliminated rather than expanded.

ALI, *Principles of Corporate Governance: Analysis and Recommendations* §7.03 (T.D. No. 11, 1991); ABA, *Model Business Corporation Act* §7.42(1) (1990 revision). So, too, Maryland might be influenced by the burgeoning research casting doubt on the value of derivative litigation for investors. E.g., Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55 (1991); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991); Mark L. Cross, Wallace N. Davidson & John H. Thornton, *The Impact of Directors' and Officers' Liability Suits on Firm Value*, 56 J. Risk & Insurance 128 (1989); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261 (1986). State legislatures have begun to adopt universal-demand requirements. 111 S. Ct. at 1719 n.7 (collecting statutes). There is no counter movement toward enlarging the futility exception. We think it likely, then, that if Maryland does not abolish the futility exception it will cast its lots with the states that require demand on directors who face no substantial risk of personal liability. As Kamen has never argued that the Fund's seven independent directors could be personally liable – indeed, Kamen has never argued that they even noticed the single sentence of which she complains – it follows that the directors' approval of the proxy statement does not make demand futile.

Yet we know, Kamen responds, that these directors were *not* willing to put things to rights. After she filed this suit, the directors moved to dismiss her claims on the merits. During depositions, several directors took a dim

view of Kamen's substantive allegations. These objections demonstrate, she maintains, that demand was futile. This argument confuses futility with failure. A demand is "futile" only if the directors' minds are closed to argument. That the directors disagreed with an argument could show their unwillingness to listen, but also could show that the argument was feeble. See *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984). Demand enables the directors to take the leading role in managing the corporation. Conscientious managers may conclude that legal action is unjustified because not meritorious, or because it would subject the firm to injury. This is why courts assess futility *ex ante* rather than *ex post*. See Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice* §5.03 at 31 (1987). To say that a demand would have been futile because directors proved unsympathetic to the lawsuit is like saying that sending Mickey Mantle to the plate with the bases loaded was futile because he struck out.

Kamen insists that *Parish* equates opposition with futility, but we do not read the case so. The passage Kamen cites, 242 A.2d at 546-47, deals with demand on investors (the members of the agricultural cooperative) rather than demand on directors. Demand on investors is rarely necessary, in part because investors lack the information available to the managers and are prone to approve the managers' acts reflexively, as they did in *Parish*. Inability of scattered investors to assess managerial acts astutely is why only *unanimous* action can ratify waste, and why courts almost never require a demand on investors. Maryland's holding that the members' non-unanimous ratification of the directors' acts does not block the derivative suit puts that state in line with the

dominant view. It does not imply that Maryland would blaze a lonely path and treat directors' substantive opposition to the derivative suit as retroactively excusing demand. So far as we know, no state treats the directors' failure to capitulate in the lawsuit as forfeiting the firm's entitlement to demand before the suit commences. Directors will (and should) oppose weak claims. If that opposition eliminated the need for demand, we would reach the curious pass that claims so weak that they should not be pursued at all could go straight to court, while claims strong enough to litigate about should be presented to the directors. Kamen does not tell us why Maryland would adopt such a topsy-turvy rule after saying in *Waller* that demand is a valuable screen against weak claims: "[I]f the courts would open their doors to all complaining stockholders without requiring them to show that it was impossible to obtain redress through regular corporate action, litigation of this kind would be endless." 187 Md. at 192, 49 A.2d at 453. If substantive opposition retroactively excuses demand, why would any investor demand action? If the firm opposed the suit, then the opposition would show the futility of demand; if however the firm embraced and prosecuted the plaintiff's claim, then the plaintiff would receive all the relief the court could have awarded. Demand would be defunct. Yet Maryland says that demand is the norm. It must follow that the directors' substantive opposition does not obviate demand.

For the reasons given in our initial opinion, 908 A.2d at 1347-50, the district court's judgment is reversed to the extent it held that Kamen is not entitled to pursue a direct action under §36(b) of the Investment Company Act. The Supreme Court denied the Fund's petition for certiorari

to review that aspect of our decision, 111 S.Ct. 558 (1990), as it denied Kamen's petition to the extent it sought review of our holding, 908 F.2d at 1350-51, that she is not entitled to a jury trial of her claim under §36(b), 111 S.Ct. 554 (1990). The case is remanded for further proceedings under § 36(b). The judgment is affirmed to the extent it holds that Kamen's failure to make a demand on the Fund's directors blocks a derivative action under §20(a).

A true Copy:

Teste:

*Clerk of the United States Court of
Appeals for the Seventh Circuit*

Supreme Court Decision dated May 20, 1991

Jill S. KAMEN, Petitioner

v.

KEMPER FINANCIAL
SERVICES, INC., et al.

No. 90-516.

Argued March 27, 1991.

Decided May 20, 1991.

Justice MARSHALL delivered the opinion of the Court.

This case calls upon us to determine whether we should fashion a federal common law rule obliging the representative shareholder in a derivative action founded on the Investment Company Act of 1940, 54 Stat. 789, 15 U.S.C. § 80a-1(a) *et seq.*, to make a demand on the board of directors even when such a demand would be excused as futile under state law. Because the scope of the demand requirement embodies the incorporating State's allocation of governing powers within the corporation, and because a futility exception to demand does not impede the purposes of the Investment Company Act, we decline to displace state law with a uniform rule abolishing the futility exception in federal derivative actions.

I

The Investment Company Act of 1940 (ICA or Act) establishes a scheme designed to regulate one aspect of the management of investment companies that provide so-called "mutual fund" services. Mutual funds pool the

investment assets of individual shareholders. Such funds typically are organized and underwritten by the same firm that serves as the company's "investment adviser." The ICA seeks to arrest the potential conflicts of interest inherent in such an arrangement. See generally *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536-541, 104 S.Ct. 831, 838-841, 78 L.Ed.2d 645 (1984); *Burks v. Lasker*, 441 U.S. 471, 480-481, 99 S.Ct. 1831, 1838-1839, 60 L.Ed.2d 404 (1979). The Act requires, *inter alia*, that at least 40% of the investment company's directors be financially independent of the investment adviser, 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19)(iii); that the contract between the adviser and the company be approved by a majority of the company's shareholders, § 801-15(a); and that the dealings of the adviser with the company measure up to a fiduciary standard, the breach of which gives rise to a cause of action by either the Securities and Exchange Commission (SEC) or an individual shareholder on the company's behalf, § 80a-35(b).

Petitioner brought this suit to enforce § 20(a) of the Act, 15 U.S.C. § 80a-20(a), which prohibits materially misleading proxy statements.¹ The complaint was styled

¹ Section 20(a) states:

"It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 80a-20(a).

as a shareholder derivative action brought on behalf of respondent Cash Equivalent Fund, Inc. (Fund), a registered investment company, against Kemper Financial Services, Inc. (KFS), the Fund's investment adviser. Petitioner alleged that KFS obtained shareholder approval of the investment-adviser contract by causing the Fund to issue a proxy statement that materially misrepresented the character of KFS' fees. See App. to Pet. for Cert. 90a-91a. Petitioner also averred that she made no precomplaint demand on the Fund's board of directors because doing so would have been futile. In support of this allegation, the complaint stated that all of the directors were under the control of KFS, that the board had voted unanimously to approve the offending proxy statement, and that the board had subsequently evidenced its hostility to petitioner's claim by moving to dismiss. See *id.*, at 92a-93a. The District Court granted KFS' motion to dismiss on the ground that petitioner had failed to plead the facts excusing demand with sufficient particularity for purposes of Federal Rule of Civil Procedure 23.1. See 659 F.Supp. 1153, 1160-1163 (N.D.Ill.1987).

The Court of Appeals affirmed the dismissal of petitioner's § 20(a) claim. See 908 F.2d 1338 (CA7 1990). Like the District Court, the Court of Appeals concluded that petitioner's failure to make a precomplaint demand was

(Continued from previous page)

SEC regulations require proxy statements issued by a registered investment company to comply with the proxy statement rules promulgated under the Securities Exchange Act of 1934. See 17 CFR § 270.20a-1(a) (1990). The latter rules prohibit materially misleading statements. See § 240.14a-9.

fatal to her case. Drawing heavily on the American Law Institute's Principles of Corporate Governance (Tent. Draft No. 8, Apr. 15, 1988), the Court of Appeals concluded that the futility exception does little more than generate wasteful threshold litigation collateral to the merits of the derivative shareholder's claim. For that reason, the court adopted as a rule of federal common law the ALI's so-called "universal demand" rule, under which the futility exception is abolished. See 908 F.2d, at 1344; see also ALI, Principles of Corporate Governance, *supra*, § 7.03(a)-(b), and comment *a*.² The court acknowledged this Court's precedents holding that courts should incorporate state law when fashioning federal common law rules to fill the interstices of private causes of action brought under federal securities laws. See 908 F.2d, at 1342. Nonetheless, because petitioner had neglected until her reply brief to advert to the established status of the futility exception under the law of Maryland – the State in which the Fund is incorporated – the court held that petitioner's challenge to the court's power to adopt the ALI's universal-demand rule "c[ame] too late" to be considered. *Ibid*.³

² The ALI's proposal would excuse demand "only when the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result." Principles of Corporate Governance § 7.03(b). The Court of Appeals did not specifically address this aspect of the ALI's proposal, although the court did reject the possibility that "exigencies of time" would warrant dispensing with demand. 908 F.2d at 1344.

³ The Court of Appeals also reversed the District Court's conclusion that petitioner could not sue under § 36(b) of the

We granted certiorari, 498 U.S. ___, 111 S.Ct. 554, 112 L.Ed.2d 561 (1990), and now reverse.

II

The derivative form of action permits an individual shareholder to bring "suit to enforce a *corporate* cause of action against officers, directors, and third parties." *Ross v. Bernhard*, 396 U.S. 531, 534, 90 S.Ct. 733, 736, 24 L.Ed.2d 729 (1970). Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of "faithless directors and managers." *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548, 69 S.Ct. 1221, 1226, 93 L.Ed. 1528 (1949). To prevent abuse of this remedy, however, equity courts established as a "precondition for the suit" that the shareholder demonstrate "that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions." *Ross v. Bernhard*, *supra*, 396 U.S., at 534, 90 S.Ct., at 736. This requirement is accommodated by Federal Rule of Civil Procedure 23.1, which states in pertinent part:

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Act, 15 U.S.C. § 80a-35(b), because she was not an adequate shareholder representative under Rule 23.1. See 908 F.2d at 1347-1349. After holding that petitioner was not entitled to a jury trial, the Court of Appeals remanded for further proceedings on petitioner's § 36(b) claim. See *id.*, at 1350-1351. No aspect of the Court of Appeals' disposition of petitioner's § 36(b) claim is before this Court.

"The complaint [in a shareholder derivative action] shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort."

But although Rule 23.1 clearly *contemplates* both the demand requirement and the possibility that demand may be excused, it does not *create* a demand requirement of any particular dimension. On its face, Rule 23.1 speaks only to the adequacy of the shareholder representative's pleadings. Indeed, as a rule of procedure issued pursuant to the Rules Enabling Act, Rule 23.1 cannot be understood to "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2072(b). The purpose of the demand requirement is to "affor[d] the directors an opportunity to exercise their reasonable business judgment and 'waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right.'" *Daily Income Fund, Inc. v. Fox*, 464 U.S., at 533, 104 S.Ct., at 836-837, quoting *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463, 23 S.Ct. 157, 160, 47 L.Ed. 256 (1903). Ordinarily, it is only when demand is excused that the shareholder enjoys the right to initiate "suit on behalf of his corporation in disregard of the directors' wishes." R. Clark, *Corporate Law* § 15.2, p. 640 (1986). In our view, the function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of "substance," not "procedure." See *Daily Income Fund, Inc. v. Fox*, *supra*, 464 U.S., at 543-544, and n.

2, 104 S.Ct., at 842-843, and n. 2 (STEVENS, J., concurring in judgment); cf. *Cohen v. Beneficial Loan Corp.*, *supra*, 337 U.S., at 555-557, 69 S.Ct., at 1229-1230 (state security-for-costs statute limits shareholder's "substantive" right to maintain derivative action); *Hanna v. Plumer*, 380 U.S. 460, 477, 85 S.Ct. 1136, 1147, 14 L.Ed.2d 8 (1965) (Harlan, J., concurring) (rule is "substantive" when it regulates derivative shareholder's primary conduct in exercise of corporate managerial power). Thus, in order to determine whether the demand requirement may be excused by futility in a derivative action founded on § 20(a) of the ICA,⁴ we must identify the source and content of the substantive law that defines the demand requirement in such a suit.

⁴ We have never addressed the question whether § 20(a) creates a shareholder cause of action, either direct or derivative. The SEC, as *amicus curiae*, urges us to hold that a shareholder may bring suit under § 20(a) but only on his own behalf. The parties did not litigate this question in the Court of Appeals, and because that court disposed of petitioner's claim on different grounds, it declined to address whether § 20(a) creates a derivative action. See 908 F.2d 1338, 1341 (CA7 1990). The petition for certiorari likewise did not raise this issue in the questions presented. Because the question whether § 20(a) supports a derivative action is not jurisdictional, see *Burks v. Lasker*, 441 U.S. 471, 476, n. 5, 99 S.Ct. 1831, 1836, n. 5, 60 L.Ed.2d 404 (1979), and because we do not ordinarily address issues raised only by *amici*, see, e.g., *United Parcel Service, Inc. v. Mitchell*, 451 U.S. 56, 60, n. 2, 101 S.Ct. 1559, 1562-1563, n. 2., 67 L.Ed.2d 732 (1981), we leave this question for another day. See *Burks v. Lasker*, *supra*, 441 U.S., at 475-476, 99 S.Ct., at 1835-1836 (assuming existence of derivative action under ICA for purposes of determining power of independent directors to terminate suit).

III

A

It is clear that the contours of the demand requirement in a derivative action founded on the ICA are governed by *federal* law. Because the ICA is a federal statute, any common law rule necessary to effectuate a private cause of action under that statute is necessarily federal in character. See *Burks v. Lasker*, 441 U.S., at 476-477, 99 S.Ct., at 1836; *Sola Electric Co. v. Jefferson Electric Co.*, 317 U.S. 173, 176, 63 S.Ct. 172, 173, 87 L.Ed. 165 (1942).

It does not follow, however, that the content of such a rule must be wholly the product of a federal court's own devising. Our cases indicate that a court should endeavor to fill the interstices of federal remedial schemes with uniform federal rules only when the scheme in question evidences a distinct need for nationwide legal standards, see, e.g., *Clearfield Trust Co. v. United States*, 318 U.S. 363, 366-367, 63 S.Ct. 573, 574-575, 87 L.Ed. 838 (1943), or when express provisions in analogous statutory schemes embody congressional policy choices readily applicable to the matter at hand, see, e.g., *Boyle v. United Technologies Corp.*, 487 U.S. 500, 511-512, 108 S.Ct. 2510, 2517-2518, 101 L.Ed.2d 442 (1988); *DelCostello v. Teamsters*, 462 U.S. 151, 169-172, 103 S.Ct. 2281, 2293-2295, 76 L.Ed.2d 476 (1983). Otherwise, we have indicated that federal courts should "incorporat[e] [state law] as the federal rule of decision," unless "application of [the particular] state law [in question] would frustrate specific objectives of the federal programs." *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728, 99 S.Ct. 1448, 1458, 59 L.Ed.2d 711 (1979). The

presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards. See *id.*, at 728-729, 739-740, 99 S.Ct., at 1458-1459, 1464-1465 (commercial law); *Reconstruction Finance Corp. v. Beaver County*, 328 U.S. 204, 210, 66 S.Ct. 992, 995, 90 L.Ed. 1172 (1946) (property law); see also *De Sylva v. Ballentine*, 351 U.S. 570, 580-581, 76 S.Ct. 974, 980, 100 L.Ed. 1415 (1956) (borrowing family law because of primary state responsibility).

Corporation law is one such area. See *Burks v. Lasker*, *supra*. The issue in *Burks* was whether the disinterested directors of a registered investment company possess the power to terminate a nonfrivolous derivative action founded on the ICA and the Investment Advisers Act of 1940 (IAA). We held that a federal court should look to state law to answer this question. See *id.*, 441 U.S., at 477-485, 99 S.Ct., at 1836-1841. " 'Corporations,' " we emphasized, " 'are creatures of state law,' and it is state law which is the font of corporate directors' powers." *Id.*, at 478, 99 S.Ct., at 1837, quoting *Cort v. Ash*, 422 U.S. 66, 84, 95 S.Ct. 2080, 2090, 45 L.Ed.2d 26 (1975). We discerned nothing in the limited regulatory objectives of the ICA or IAA that evidenced a congressional intent that "federal courts . . . fashion an entire body of federal corporate law out of whole cloth." 441 U.S., at 480, 99 S.Ct., at 1838. Consequently, we concluded that gaps in these statutes bearing on the allocation of governing power within the corporation should be filled with state law "unless the state la[w] permit[s] action prohibited by the Acts, or

unless '[its] application would be inconsistent with the federal policy underlying the cause of action. . . . ' " *Id.*, at 479, 99 S.Ct., at 1837, quoting *Johnson v. Railway Express Agency, Inc.*, 421 U.S. 454, 465, 95 S.Ct. 1716, 1722, 44 L.Ed.2d 295 (1975).

Defending the reasoning of the Court of Appeals, KFS argues that petitioner waived her right to the application of anything other than a uniform federal rule of demand because she failed to advert to state law until her reply brief in the proceedings below. We disagree. When an issue or claim is properly before the court, the court is not limited to the particular legal theories advanced by the parties, but rather retains the independent power to identify and apply the proper construction of governing law. See, e.g., *Arcadia v. Ohio Power Co.*, 498 U.S. ___, ___, 111 S.Ct. 415, ___, 112 L.Ed.2d 374 (1990). It is not disputed that petitioner effectively invoked federal common law as the basis of her right to forgo demand as futile. Having undertaken to decide this claim, the Court of appeals was not free to promulgate a federal common law demand rule without identifying the proper *source* of federal common law in this area. Cf. *Lamar v. Micou*, 114 U.S. 218, 223, 5 S.Ct. 857, 859, 29 L.Ed. 94 (1885) ("The law of any State of the Union, whether depending upon statutes or upon judicial opinions, is a matter of which the courts of the United States are bound to take judicial notice, without plea or proof"); *Bowen v. Johnston*, 306 U.S. 19, 23, 59 S.Ct. 442, 444, 83 L.Ed. 455 (1939) (same). Indeed, we note that the Court of Appeals viewed itself as free to adopt the American Law Institute's universal-demand rule even though *neither* party addressed

whether the futility exception should be abolished as a matter of federal common law.⁵

The question, then, is whether the Court of Appeals drew its universal-demand rule from an improper source when it disregarded state law relating to the futility exception. To answer that question, we must first determine whether the demand requirement comes within the purview of *Burks'* presumption of state-law incorporation, that is, whether the scope of the demand requirement affects the allocation of governing power within the corporation. If so, we must then determine whether a futility exception to the demand requirement impedes the policies underlying the ICA.⁶

⁵ We do not mean to suggest that a court of appeals should not treat an unasserted claim as waived or that the court has no discretion to deny a party the benefit of favorable legal authorities when the party fails to comply with reasonable local rules on the timely presentation of arguments. See generally *Singleton v. Wulff*, 428 U.S. 106, 121, 96 S.Ct. 2868, 2877, 49 L.Ed.2d 826 (1976). Nonetheless, if a court undertakes to sanction a litigant by deciding an effectively raised claim according to a truncated body of law, the court should refrain from issuing an opinion that could reasonably be understood by lower courts and nonparties to establish binding circuit precedent on the issue decided.

⁶ KFS argues that *Burks* is not controlling because this Court established a uniform, federal common law demand requirement in *Hawes v. Oakland*, 104 U.S. 450, 26 L.Ed. 827 (1882). This contention is unpersuasive. In *Hawes*, this Court articulated a demand requirement (along with a futility exception) to protect the managerial prerogatives of the corporate directors and to prevent the collusive manufacture of diversity

B

Because the contours of the demand requirement – when it is required, and when excused – determine *who* has the power to control corporate litigation, we have little trouble concluding that this aspect of state law relates to the allocation of governing powers within the corporation. The purpose of requiring a precomplaint demand is to protect the directors' prerogative to take over the litigation or to oppose it. See, e.g., *Spiegel v.*

(Continued from previous page)

jurisdiction. See *id.*, at 460-461. The latter objective, which is clearly a proper aim of federal law, is now governed not by a federal common law doctrine of demand but rather by the express terms of Federal Rule of Civil Procedure 23.1, which requires the plaintiff to allege that "the action is not a collusive one to confer jurisdiction on a court of the United States." See also *Smith v. Sperling*, 354 U.S. 91, 95-98, 77 S.Ct. 1112, 1114-1116, 1 L.Ed.2d 1205 (1957) (district court should look to "face of the pleadings and [to] nature of the controversy" to resolve jurisdictional issues in derivative action founded on diversity). Insofar as *Hawes* aspired to regulate the substantive managerial prerogatives of directors in a derivative action founded on diversity of citizenship, the demand rule established in that case does not survive *Erie R. Co. v. Tompkins*, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938). Cf. *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 555-557, 69 S.Ct. 1221, 1229-1231, 93 L.Ed. 1528 (1949) (federal court sitting in diversity must apply state security-for-costs statute in derivative action). Of course, the principles recognized in *Erie* place no limit on a federal court's power to fashion federal common law rules necessary to effectuate a derivative remedy founded on federal law. See *Burks v. Lasker*, 441 U.S., at 476, 99 S.Ct., at 1836. But in this respect, whatever philosophy of federal common lawmaking can be gleaned from *Hawes* has been eclipsed by the philosophy of *Burks*. In sum, *Hawes* is irrelevant to our disposition of this case.

Buntrock, 571 A.2d 767, 773 (Del.1990). In most jurisdictions, the board's decision to do the former ends the shareholder's control of the suit, see R. Clark, *Corporate Law* § 15.2, p. 640 (1986), while its decision to do the latter is subject only to the deferential "business judgment rule" standard of review, see, e.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784, and n. 10 (Del.1981). Thus, the demand requirement implements "the basic principle of corporate governance that the decisions of a corporation – including the decision to initiate litigation – should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox*, 464 U.S., at 530, 104 S.Ct., at 835.

To the extent that a jurisdiction recognizes the futility exception to demand, the jurisdiction places a *limit* upon the directors' usual power to control the initiation of corporate litigation. Although "jurisdictions differ widely in defining the circumstances under which demand on directors will be excused," D. DeMott, *Shareholder Derivative Actions* § 5:03, p. 35 (1987), demand typically is deemed to be futile when a majority of the directors have participated in or approved the alleged wrongdoing, see, e.g., *Barr v. Wackman*, 36 N.Y.2d 371, 381, 368 N.Y.S.2d 497, 507, 329 N.E.2d 180, 188 (1975), or are otherwise financially interested in the challenged transactions, see, e.g., *Aronson v. Lewis*, 473 A.2d 805, 814 (Del.1984).⁷ By

⁷ All States require that a shareholder make a pre-complaint demand on the directors. See D. DeMott, *Shareholder Derivative Actions* § 5:03, p. 23 (1987); *id.*, at 65, n. 1 (Supp.1990). Only a few States, however, have adopted a universal-demand rule. See Fla.Stat. Ann. § 607.07401(2) (Supp.1991); Ga.Code Ann. § 14-2-742 (1989); Mich.Comp.Laws Ann. § 450.1493a(a) (1990).

permitting the shareholder to circumvent the board's business judgment on the desirability of corporate litigation, the "futility" exception defines the circumstances in which the shareholder may exercise this particular incident of managerial authority. See, e.g., *Zapata Corp. v. Maldonado*, *supra*, at 784.

The futility exception to the demand requirement may also determine the scope of the directors' power to terminate derivative litigation once initiated – the very aspect of state corporation law that we were concerned with in *Burks*. In many (but not all) States, the board may delegate to a committee of disinterested directors the board's power to control corporate litigation. See generally R. Clark, *supra*, § 15.2.3. Some of these jurisdictions treat the decision of a special litigation committee to terminate a derivative suit as automatically entitled to deference under the "business judgment rule." See, e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 631-633, 419 N.Y.S.2d 920, 927-928, 393 N.E.2d 994, 1001-1002 (1979). Others, including Delaware, defer to the decision of a special litigation committee only in a "demand required" case; in a "demand excused" case, these States first require the court to confirm the "independence, good faith and . . . reasonable investigat[ory]" efforts of the committee and then authorize the court to exercise its "own independent business judgment" in assessing whether to enforce the committee's recommendation, *Zapata Corp. v. Maldonado*, *supra*, at 788-789; see *Spiegel v. Buntrock*, *supra*, at 778. Thus, in these jurisdictions, "the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability." *Aronson v. Lewis*, *supra*, at 812.

Superimposing a rule of universal-demand over the corporate doctrine of these States would clearly upset the balance that they have struck between the power of the individual shareholder and the power of the directors to control corporate litigation. Under the law of Delaware and the States that follow its lead, a shareholder who makes demand may not later assert that demand was in fact excused as futile. *Spiegel v. Buntrock*, 571 A.2d, at 775. Once a demand has been made, the decision to block or to terminate the litigation rests solely on the business judgment of the directors. See *ibid.* Thus, by taking away the shareholder's right to withhold demand under the circumstances where demand is deemed to be futile under state law, a universal-demand rule, in direct contravention of the teachings of *Burks*, would *enlarge* the power of directors to control corporate litigation. See 441 U.S., at 478-479, 99 S.Ct., at 1837-1838.

KFS contends that the scope of a federal common law demand requirement need not be tied to the allocation of power to control corporate litigation. This is so, KFS suggests, because a court adjudicating a derivative action based on federal law could sever the requirement of shareholder demand from the standard used to review the directors' decision to bar initiation of, or to terminate, the litigation. Drawing on the ALI's Principles of Corporate Governance, the Court of Appeals came to this same conclusion. See 908 F.2d, at 1343-1344. Freed from the question of the directors' power to control the litigation, the universal-demand requirement, KFS maintains, would force would-be derivative suit plaintiffs to exhaust their intracorporate remedies before filing suit and would

spare both the courts and the parties the expense associated with the often protracted threshold litigation that attends the collateral issue of demand futility.

We reject this analysis. Whatever its merits as a matter of legal reform, we believe that KFS' proposal to detach the demand standard from the standard for reviewing board action would require a quantum of federal common lawmaking that exceeds federal courts' interstitial mandate. Under state law, the determination whether a derivative representative can initiate a suit without making demand typically is made at the outset of the litigation and is based on the application of the State's futility doctrine to circumstances as they then exist. *D. DeMott, supra*, § 5:03, at 31. Under KFS' proposal, federal courts would be obliged to develop a body of principles that would replicate the substantive effect of the State's demand futility doctrine but that would be applied *after* demand has been made and refused. The ALI, for example, has developed an elaborate set of standards that calibrates the deference afforded the decision of the directors to the character of the claim being asserted by the derivative plaintiff. See ALI, *Principles of Corporate Governance* § 7.08 (Tent. Draft No. 8, Apr. 15, 1988); *id.*, § 7.08, Comment *c*, p. 120 (noting that Principles "dra[w] a basic distinction between the standard of review applicable to actions that are founded on a breach of the duty of care and the standard of review applicable to actions that are founded on a breach of the duty of loyalty").⁸

⁸ The American Bar Association's Model Business Corporation Act likewise abolishes the futility exception to demand.

Whether a federal court adopts the ALI's standards wholesale or instead attempts to devise postdemand review standards more finely tuned to the distinctive allocation of managerial decisionmaking power embodied in any given jurisdiction's demand futility doctrine, KFS' suggestion would impose upon federal courts the very duty "to fashion an entire body of federal corporate law" that *Burks* sought to avoid. 441 U.S., at 480, 99 S.Ct., at 1838.

Such a project, moreover, would necessarily infuse corporate decisionmaking with uncertainty. For example, insofar as Delaware law does not permit a shareholder to make a demand and later to assert its futility, receipt of demand makes it crystal clear to the directors of a Delaware corporation that the decision whether to commit the corporation to litigation lies solely in their discretion. See *Spiegel v. Buntrock*, *supra*, at 775. Were we to impose a universal-demand rule, however, the directors of such a corporation could draw no such inference from receipt of demand by a shareholder contemplating a federal derivative action. Because the entitlement of the directors'

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See Model Business Corporation Act § 7.42(1), reprinted in 45 Bus.Law. 1241, 1244 (1990). And like the ALI's Principles of Corporate Governance, the Model Business Corporation Act spells out a detailed set of principles for identifying the circumstances in which the decision of the directors is entitled to deference. Model Business Corporation Act § 7.44, reprinted in 45 Bus.Law., at 1246-1247. The official commentary acknowledges that these review standards "diffe[r] in certain . . . respects from the law as it has developed in Delaware and been followed in a number of other states." § 7.44, *Official Comment*, reprinted in 45 Bus.Law., at 1250.

decision to deference in such a case would depend on the court's application of independent review standards somewhere down the road, the directors could do no more than speculate as to whether they should assess the merits of the demand themselves or instead incur the time and expense associated with forming a special litigation committee; indeed, at that stage, even the deference due the decision of such a committee would be unclear. The directors' dilemma would be especially acute if the shareholder were proposing to join state-law and federal claims, see *RCM Securities Fund, Inc. v. Stanton*, 928 F.2d 1318, 1327-1328 (CA2 1991), a common form of action in federal derivative practice, see D. DeMott, *Shareholder Derivative Actions* § 4:08, 71 (1987).⁹ It is to avoid precisely this type of disruption to the internal affairs of the corporation that *Burks* counsels against establishing competing federal- and state-law principles on the allocation of managerial prerogatives within the corporation. See generally Restatement (Second) of Conflict of Laws § 302, Comment *e*, p. 309 (1971) ("Uniform treatment of directors, offices and shareholders is an important objective which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law").

⁹ Indeed, because "[i]n most instances, the shareholder need not specify his legal theory" in his demand, *Allison v. General Motors Corp.*, 604 F.Supp. 1106, 1117 (Del.1985), *aff'd*, 782 F.2d 1026 (CA3 1985), the directors frequently will not be able to tell whether the underlying claim is founded on state law or on federal law. This uncertainty will further complicate managerial decisionmaking.

Finally, in our view, KFS overstates the likely judicial economies associated with a federal universal-demand rule when coupled with independent standards of review. Requiring demand in all cases, it is true, might marginally enhance the prospect that corporate disputes would be resolved without resort to litigation; however, nothing disables the directors from seeking an accommodation with a representative shareholder even after the shareholder files his complaint in an action in which demand is excused as futile. At the same time, the rule proposed by KFS is unlikely to avoid the high collateral litigation costs associated with the demand futility doctrine. So long as a federal court endeavors to reproduce through independent review standards the allocation of managerial power embodied in the demand futility doctrine, KFS' universal-demand rule will merely shift the focus of threshold litigation from the question whether demand is excused to the question whether the directors' decision to terminate the suit is entitled to deference under federal standards. Under these circumstances, we do not view the advantages associated with KFS' proposal to be sufficiently apparent to justify replacing "the entire corpus of state corporation law" relating to demand futility. See *Burks v. Lasker*, 441 U.S., at 478, 99 S.Ct., at 1837.

C

We would nonetheless be constrained to displace state law in this area were we to conclude that the futility exception to the demand requirement is inconsistent with the policies underlying the ICA. See *id.*, at 479-480, 99

S.Ct., at 1837-1838. KFS contends that the futility exception does impede the regulatory objectives of the statute. As KFS notes, the requirement that at least 40% of the board of directors be financially independent of the investment adviser constitutes "[t]he cornerstone of the ICA's effort to control conflicts of interest within mutual funds." *Id.*, at 482, 99 S.Ct., at 1839. KFS argues that the futility exception undermines the "watchdog" role assigned to the independent directors, see *id.*, at 484-485, 99 S.Ct., at 1840-1841, because empowering a shareholder to institute corporate litigation without the permission of the board allows the shareholder to "usurp" the independent directors' managerial oversight responsibility. See Brief for Respondent KFS 40.

We disagree. KFS' argument misconceives the means by which Congress intended independent directors to exercise their oversight function under the ICA. As we emphasized in *Burks*, the ICA embodies a congressional expectation that the independent directors would "loo[k] after the interests of the [investment company]" by "exercising the authority granted to them *by state law*." 441 U.S., at 485, 99 S.Ct., at 1840 (emphasis added). Indeed, we specifically noted in *Burks* that "[t]he ICA does not purport to be the source of authority for managerial power; rather the Act functions primarily to 'impos[e] controls and restrictions on the internal management of investment companies.'" *Id.*, at 478, 99 S.Ct., at 1837, quoting *United States v. National Assn. of Securities Dealers, Inc.*, 422 U.S. 694, 705 n. 13, 95 S.Ct. 2427, 2436 n. 13, 45 L.Ed.2d 486 (1975) (emphasis added by *Burks* Court). We thus discern no policy in the Act that would require us to

give the independent directors, or the boards of investment companies as a whole, *greater* power to block shareholder derivative litigation than these actors possess under the law of the State of incorporation.

KFS also ignores the role that the ICA clearly envisions for shareholders in protecting investment companies from conflicts of interest. As we have pointed out, § 36(b) of the ICA expressly provides that an individual shareholder may bring an action on behalf of the investment company for breach of the investment adviser's fiduciary duty. 15 U.S.C. § 80a-35(b). Congress added § 36(b) to the ICA in 1970 because it concluded that the shareholders should not have to "rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board." *Daily Income Fund, Inc. v. Fox*, 464 U.S., at 540, 104 S.Ct., at 841. This legislative background informed our conclusion in *Fox* that a shareholder action "on behalf of" the company under § 36(b) is direct rather than derivative and can therefore be maintained without *any* pre-complaint demand on the directors. Under these circumstances, it can hardly be maintained that a shareholder's exercise of his state-created prerogative to initiate a derivative suite without the consent of the directors frustrates the broader policy objectives of the ICA.

IV

We reaffirm the basic teaching of *Burks v. Lasker*, *supra*: where a gap in the federal securities laws must be bridged by a rule that bears on the allocation of governing powers within the corporation, federal courts should

incorporate *state* law into federal common law unless the particular state law in question is inconsistent with the policies underlying the federal statute. The scope of the demand requirement under state law clearly regulates the allocation of corporate governing powers between the directors and individual shareholders. Because a futility exception to demand does not impede the regulatory objectives of the ICA, a court that is entertaining a derivative action under that statute must apply the demand futility exception as it is defined by the law of the State of incorporation. The Court of Appeals thus erred by fashioning a uniform federal common law rule abolishing the futility exception in derivative actions founded on the ICA.¹⁰

Accordingly, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

¹⁰ KFS maintains that we should nonetheless affirm the dismissal of petitioner's cause of action because petitioner did not plead the grounds excusing demand with sufficient particularity for purposes of Federal Rule of Civil Procedure 23.1. Because the Court of Appeals applied a universal-demand rule, it never addressed the sufficiency of petitioner's complaint with reference to the futility exception as defined by the law of Maryland, the State in which the Fund is incorporated. Rather than take the issue up for the first time ourselves, we leave for the Court of Appeals on remand the question whether petitioner adequately pleaded excuse of demand for purposes of rule 23.1.

App. 33

Court of Appeals Decision
dated July 18, 1990

Jill S. KAMEN,

Plaintiff-Appellant,

v.

KEMPER FINANCIAL SERVICES, INC.,
and Cash Equivalent Fund,

Defendants-Appellees.

No. 89-2967.

United States Court of Appeals,
Seventh Circuit.

Argued May 11, 1990.

Decided July 18, 1990.

Before CUMMINGS, EASTERBROOK and RIPPLE,
Circuit Judges.

EASTERBROOK, Circuit Judge.

Cash Equivalent Fund is a money market mutual fund with a sweeps feature. Brokers offer the Fund to their customers as an adjunct to their principal accounts. When an account has a cash balance, a computer "sweeps" the money into the Fund, where it earns interest until the customer reinvests in stocks or other financial instruments; the Fund redeems shares automatically to supply the cash for these transactions. The Fund and its investment adviser, Kemper Financial Services, Inc., say that the extra costs of implementing a sweeps feature and the additional transactions it generates, plus the check-writing and wire transfer features of the Fund, justify a fee exceeding the norm for money market funds.

Kemper receives an annual administration fee of 0.38% of the Fund's assets. It also receives an investment management fee starting at 0.22% of the first \$500 million of the Fund's assets and dropping in increments to 0.15% of the assets exceeding \$3 billion. As a result of these fees, the Fund pays interest at a rate approximately 0.2% per annum lower than money market funds that operate passively, including one that Kemper itself manages, the Kemper Money Market Fund.

Despite the difference in fees and payouts, the Fund has grown steadily and now manages more than \$5 billion of assets. One might think this judgment of investors dispositive: offered extra services at lower interest, the Fund's investors chose the extra services; others have sent their money elsewhere to get a higher return. Whether the extra services are "worth" the price is the sort of judgment people make every day when deciding whether to buy a stripped down computer or pay extra for one with bells and whistles; our government does not try to determine whether extra features are worth a higher price.

Things are not so simple when the services are rendered by an investment adviser rather than a manufacturer or retailer of computers. Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), provides that the adviser of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services". Fiduciary duties require honest dealing. Managers of all corporations owe fiduciary duties to their firms. These duties have never been thought to justify judicial review of levels of compensation paid, short of extreme cases

amounting to waste. Nonetheless, § 36(b) has been understood in light of its legislative history to put investment advisers on leashes shorter than those of corporate managers generally, and to require the federal courts to decide whether the fees charged by investment advisers are "excessive". *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 534-41, 104 S.Ct. 831, 837-41, 78 L.Ed.2d 645 (1984).

Jill S. Kamen, who owns shares of the Fund, filed this suit under § 36(b), contending that Kemper's fees are excessive and should be reduced, with excess fees for prior years returned to the Fund. Kamen added a claim that in soliciting the investors' approval of the fee structure in 1984, the Fund had misleadingly compared the fees it pays to Kemper with the fees the Kemper Money Market Fund pays. Cash Equivalent Fund pays approximately 0.2% of its assets per annum more than the Money Market Fund does; Kamen believes that the proxy statement implied that the Fund's fees are equivalent to or lower than those paid to the Money Market Fund. Section 20(a), 15 U.S.C. § 80a-20(a), forbids using the mails to send a proxy statement that violates rules established by the Securities and Exchange Commission. The SEC has by rule under the Investment Company Act adopted its rules under the Securities Exchange Act of 1934, which forbid materially misleading statements. See 17 C.F.R. §§ 270.20a-1(a), 240.14a-9(a).

Judge Nordberg first held that § 20(a) creates a private right of action, 659 F.Supp. 1153 (N.D.Ill.1987), and then dismissed the portion of the complaint based on the proxy solicitation in 1984, holding that Kamen needed but had neglected to make a demand on the Fund's board of directors. See Fed.R.Civ.P. 23.1. He also struck Kamen's

demand for a jury trial on the demand for restitution of excessive fees. We denied Kamen's petition for mandamus in an unpublished order because any error could be reviewed on appeal from a final decision, and the Supreme Court denied certiorari over Justice White's dissent, which observed that other courts of appeals disagree with *First National Bank of Waukesha v. Warren*, 796 F.2d 999 (7th Cir.1986), on which the decision rested. *Kamen v. Nordberg*, 485 U.S. 939, 108 S.Ct. 1119, 99 L.Ed.2d 279 (1988).

Although *Fox* holds that an investor need not make a demand on the directors when proceeding under § 36(b), that claim did not last much longer. Judge Nordberg asked a magistrate to analyze Kemper's argument that Kamen is not an adequate representative of the other investors in the Fund. The magistrate recommended that the court grant summary judgment for the defendants on the § 36(b) claim because Kamen is not an adequate representative of the class under Fed.R.Civ.P. 23. Magistrate Balog wrote:

[N]o other shareholder has joined in this suit, instituted a claim, or inquired into plaintiff's action; the other shareholders have approved the fees charged by Kemper; after notice of plaintiff's allegations, the shareholders approved an increase in fees. Based on these facts, it can only be said that plaintiff's interests are antagonistic to those of the other shareholders. In such a case, plaintiff cannot adequately protect those interests. . . . It is apparent from the record as it stands that plaintiff's concerns are not those of a class, but are a private

matter. As such, plaintiff cannot maintain this suit as a class action.

Judge Aspen, to whom the case was transferred for decision, adopted the magistrate's report and granted the "motion for summary judgment on the issue of plaintiff's adequacy as a class representative. This cause may proceed, if plaintiff so chooses, as a non-class action." After the parties pointed out that the suit was not filed as a class action, and that adequacy or representation is material (if at all) only under Rule 23.1, which governs derivative actions, the court entered judgment for the defendants, stating that because "plaintiff was adjudicated as a non-adequate representative plaintiff cannot proceed individually".

Kamen's appeal presents three questions: whether the § 20 claim should have been dismissed for failure to make a demand on the directors; whether the § 36(b) claim should have been dismissed because she stands alone among the Fund's shareholders; and whether, if the § 36(b) claim should be reinstated, she would be entitled to a jury trial. Defendants maintain that only questions about the adequacy of representation are properly before us, because only that question was resolved in the final decision, and the notice of appeal identified only that decision as the subject of appeal. Defendant's misunderstand the rules governing issues that may be litigated on appeal. An appeal from the final judgment brings up for review all decisions that shaped the contours of that judgment. *E.g., Chaka v. Lane*, 894 F.2d 923 (7th Cir.1990); *Kaszuk v. Bakery & Confectionery Union*, 791 F.2d 548 (7th Cir.1986). It is unnecessary to identify earlier interlocutory orders in the notice of appeal. These orders may not

themselves be appealed; they are not "final" and so are outside the scope of 28 U.S.C. § 1291. Kamen's notice of appeal specified the final decision, and we have jurisdiction to review all of the legal questions preserved in the district court and in this court affecting the validity of that decision.

I

Kamen's complaint as finally amended alleges that she did not make a demand on the board of directors because the seven independent directors (of the ten-member board) "receive aggregate remuneration of approximately \$300,000 a year for serving as directors of the Fund and all of the other funds in the Kemper group" and therefore "are dependent upon the subservient to" Kemper. It alleges in addition that demand would be futile because the Fund solicited the proxies, so a demand would request that the directors sue themselves, and that because the Fund has asked for the dismissal of the suit on the merits the directors obviously are not interested in pursuing the claims. Judge Nordberg thought these allegations insufficient to excuse a demand under Rule 23.1, as do we.

It is far from clear that Rule 23.1 applies to a suit under § 20 of the Investment Advisers Act. The Rule applies to a "derivative action brought . . . to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it". Violations of § 20 do not yield rights "of the corporation" in the customary sense. Kamen does not sue in the right of the Fund; she sues the Fund for injury

done her by the Fund. The theory of a suit under the proxy rules is that the corporation violated a right of the investor to truthful information. If the investor recovers against the corporation, it may in turn seek to recover from its directors, but the principal wrong is by the corporation against the investors. Kamen conceded in the district court, and again at oral argument in this court, that Rule 23.1 applies to her claim under § 20. Perhaps she did this because she seeks as relief a payment to the Fund, and not a remedy for the investors personally. Whatever the reason for the concession, the question is not presented and we express no opinion on it. Similarly, we express no view on the question whether § 20 creates a private right of action, and if so what the appropriate remedy may be. The district court held that the statute creates a right of action, 659 F.Supp. at 1156-60; our conclusion concerning the demand requirement makes it unnecessary to decide whether to imply such a right. See *Burks v. Lasker*, 441 U.S. 471, 475-76 & n. 5, 99 S.Ct. 1831, 1835-36 & N. 5, 60 L.Ed.2d 404 (1979).

The district court asked whether Kamen had satisfied the demand requirement of Rule 23.1, and the briefs on appeal debate the issue in these terms. Yet as we held in *Starrels v. First National Bank of Chicago*, 870 F.2d 1168, 1170 (7th Cir.1989), Rule 23.1 governs pleading but does not create a demand requirement. Rule 23.1 requires the complaint to say with particularity what has been done about demand and why. Plaintiff may comply by saying that she made a demand or that a rule of law excuses demand.

What is the source of the rules requiring or excusing demand? When the claim for relief is based on state law,

we held in *Starrels*, the law of the state in which the defendant is incorporated governs. See also *Burks*, 441 U.S. at 477-78, 99 S.Ct. at 1836-37. When the claim for relief is based on federal substantive law, then federal law also governs the requirement of demand. See *Burks*, 441 U.S. at 475-77, 99 S.Ct. at 1835-37. But cf. *Fox*, 464 U.S. at 542-47, 104 S.Ct. at 841-44 (Stevens, J., concurring) (arguing that in cases under federal law there is no demand requirement unless the statute creates one). Federal common law contains a demand rule. *Hawes v. Oakland*, 104 U.S. 450, 26 L.Ed. 827 (1881).

Even when federal common law supplies the rule of decision, it may obtain that rule not from first principles but from state law. *United States v. Kimbell Foods Inc.*, 440 U.S. 715, 99 S.Ct. 1448, 59 L.Ed.2d 711 (1979). This is especially appropriate under Rule 23.1, because the demand requirement is an aspect of the division of authority between corporate managers and investors, a division usually governed by state law. *Burks* holds that federal law with respect to directors' power to dismiss derivative suits should be derived from state law, unless the state law is hostile to federal interests. Perhaps the demand requirement, too, should be absorbed from state law. Few courts have considered this possibility. Cases both before and after *Burks* hold or assume that the demand requirement is a creature of federal law. See, in addition to *Hawes* and the cases cited in *Starrels*, 870 F.2d at 1170 n.4, our own opinions in *Nussbacher v. Continental Illinois National Bank*, 518 F.2d 873 (7th Cir.1975), and *Thornton v. Evans*, 692 F.2d 1064, 1079-81 (7th Cir.1982). Not until Kamen filed her reply brief in this court had anyone doubted that federal law defines the demand

requirement in this case. Kamen's reply brief suggested that we import the rules from Maryland law. (The Fund is a Maryland corporation.) The suggestion comes too late, *Wilson v. O'Leary*, 895 F.2d 378, 384 (7th Cir.1990); we shall follow the tradition of *Hawes* and use federal common law.

The scope of the demand requirement depends on why demand *ever* is required. The demand rule could reflect a hope that the dispute will go away without litigation, that the board of directors will "do something" (or persuade the putative plaintiff that suit is pointless). Demand then initiates a form of alternative dispute resolution, much like mediation. Steps to control the volume of litigation are welcome, yet the demand rule creates more litigation than it prevents. It is difficult to identify cases in which the board's response to a demand satisfied the shareholder and thus prevented litigation; even if the board acts the shareholder may believe the board did too little. It is easy to point to hundreds of cases, including this one, in which the demand requirement was itself the centerpiece of the litigation. An approach uncertain in scope and discretionary in operation – that is, any rule except one invariably requiring or excusing demand – promotes litigation. When the stakes are high (as they frequently are in cases of this character), even a small disagreement between the parties about the application of a legal rule makes it difficult to resolve disagreements amicably.

A stronger rationale for the demand requirement is the one *Hawes* gives – that it allows directors to make a business decision about a business question: Whether to

invest the time and resources of the corporation in litigation. 104 U.S. at 457, 461-62, 26 L.Ed.827. See also *Fox*, 464 U.S. at 532-33, 104 S.Ct. at 836-37; Deborah A. DeMott, *Demand in Derivative Actions, Problems of Interpretations and Function*, 19 U.C.Davis L.Rev. 461, 484-88 (1986); Daniel R. Fischel, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 171-72 (1976). Firms must make operational decisions; if these misfire, they must decide what to do next. Each decision must be made with the interests of the corporation at heart. Whether to buy a particular combination of services at a particular price is a business decision. So too the decision to file a lawsuit about the price or pursue a different course, such as renegotiating the contract, changing the level of services, even finding a new adviser. Even doing nothing is justified when the resources of top managers required to act exceed the injury to the firm; when "something must be done", acts short of litigation could have net benefits exceeding those of litigation. If the directors run the show, then they must control litigation (versus other remedies) to the same extent as they make the initial business decision.

Choosing between litigation and some other response may be difficult, depending on information unavailable to courts and a sense of the situation in which business executives are trained. Managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism "selects out" judges who try to make business decisions. In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors. If principles such as the "business judgment rule" preserve room for

managers to err in making an operational decision, so too they preserve room to err in deciding what remedies to pursue. *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-64, 37 S.Ct. 509, 510-11, 61 L.Ed. 1119 (1917).

Consider now why plaintiffs may resist making demand. (a) Delay in starting the litigation while the board ponders may injure the firm, perhaps because the statute of limitations is about to expire, perhaps because a questionable transaction is about to occur and it will be hard to unscramble the eggs if it happens before the court can act. (b) Demand may be futile, in the sense that the members of the board are interested in the transaction and unwilling to sue themselves, or because they are so set against litigation that their minds are closed. (c) Demand may be pointless, in the sense that a substantive rule prevents the corporation from controlling the litigation. *Fox* held that only an investor or the SEC may initiate litigation under § 36(b), and it followed from the firm's inability to file its own case or prevent the investor from litigating that demand was unnecessary. Other statutes likewise may eliminate the point of making demand. (d) Demand may sometimes be imprudent from the plaintiff's perspective. Counsel who fear that the board *will* sue may hesitate before making a demand, because if the firm sues counsel will not reap the legal fees of victory. Or counsel may think that the board will pursue a strategy in litigation that his client disapproves, or settle for too little.

We will return to these four. Perhaps the most serious difficulty with demand from the perspective of plaintiffs

is the link between the making of demand and the standard courts apply to the director's decision not to sue. In Delaware, the Mother Court of corporate law, any shareholder who makes a demand is deemed to concede that demand was required. *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del.1990); *Stotland v. GAF Corp.*, 469 A.2d 421 (Del. 1983). If demand is required, then the disinterested members of the board are deemed to possess the ability to refuse to sue or control the litigation, provided their decisions are sufficiently reasoned to come within the capacious bounds of the business judgment doctrine. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del.1981); see also, e.g., *Aronson v. Lewis*, 473 A.2d 805, 813 (Del.1984). Except in extraordinary cases, then, tendering a demand to the board puts the plaintiff out of court under Delaware law. No wonder plaintiffs stoutly resist making demands.

Federal courts have never embraced Delaware's link between the making of a demand and special deference to the board's decision not to sue. See *Bach v. National Western Life Insurance Co.*, 810 F.2d 509, 513 (5th Cir.1987); *Joy v. North*, 692 F.2d 880, 888 n.7 (2d Cir.1982) (Winter, J.). See also *Alford v. Shaw*, 320 N.C. 465, 358 S.E.2d 323, 327 (1987) (rejecting a tie between demand and the standard of review). We think it would be unwise to do so. When the standard of review depends on the existence of a demand, plaintiffs have extraordinarily strong reasons not to make a demand, and corporations extraordinarily strong reasons to insist on one. Demand then becomes a threshold issue in every derivative suit, one that must be resolved in advance of discovery and on the basis of a good deal of speculation about what the board might do.

As in *Spiegel*, the plaintiff will assert that the board is unreasonable. Why ask persons with closed minds? The board will proclaim that Solomonic wisdom would be applied if only plaintiff would ask, while simultaneously asserting that the suit has no conceivable merit. It is not a pretty picture, but it is an extended and expensive one, made more so by some peculiarities in the way Delaware phrases its standards. See *Starrels*, 870 F.2d at 1174-76 (concurring opinion). As the American Law Institute has observed, "the need for demand and the standard of judicial review are logically very distinct." *Principles of Corporate Governance: Analysis and Recommendations* § 7.03 comment a at 65 (Tent. Draft No. 8, 1988). We conclude that when the demand requirement comes from federal common law, the making of a demand does not affect the standard with which the court will assess the board's decision not to sue.

Four reasons remain why demand may be inappropriate: (a) exigencies of time; (b) futility; (c) irrelevance given a substantive rule; (d) the risk that demand will lead to suit and so deprive counsel of fees that might have been obtained were it necessary to file a derivative suit. We may at once discard (d) as a legal excuse. Cases in category (c) obviously never require demand. Cases in category (a) justify filing the complaint before receiving the board's answer to the demand but do not justify failure to make a demand. When time is tight, the investor should make demand at the same time he files the complaint. See *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435, 447, 29 S.Ct. 540, 543, 53 L.Ed. 862 (1909). Category (b), futility, is the usual sticking point. The plaintiff asserts that the board is interested or

intransigent; the board asserts that it is reasonable and wise. Courts predictably have great difficulty deciding who is right when, as is usual, it must decide such questions on the pleadings.

At least in principle the rationale of the demand requirement implies a futility exception. If courts would not respect the directors' decision not to file suit, then demand would be an empty formality. When all directors have a financial stake in the transaction, their decision not to sue themselves would carry little weight with a court. Or perhaps all of the directors are so ensnared in the transaction that even when only the duty of care is at stake, their judgment could not be respected. Again demand seems an empty gesture. Courts dispense with futile gestures.

"In principle" is an important qualifier. In practice the futility exception to the demand rule has produced gobs of litigation. It is this exception that has sapped the potential role of the demand requirement as an alternative dispute resolution mechanism. Hundreds of cases opine on whether demand is or is not futile. Difficulties in sorting cases into demand-required and demand-excused bins are not worth incurring, once we sever the link between demand and the standard of review (as we have done). The American Law Institute recommends that courts abolish the "futility" exception to the demand rule, turning demand into an exhaustion requirement with much the same scope and function as the exhaustion requirement in the law of collateral review of criminal convictions. *Principles of Corporate Governance* §§ 7.03, 7.08, and commentary at 64-71 (Tent. Draft No. 8, 1988). "The futility exception . . . [is] ambiguous in scope and

has proven a prodigious generator of litigation." *Id.* at 64. The time has come to do away with it. If demand is useful, then let the investor make one; if indeed futile, the board's response will establish that soon enough. In either case, the litigation may proceed free of arguments about whether a demand should have been made in the first place. The virtue of simplification may be seen by considering three of the common battles about the meaning of "futility".

1. The plaintiff may say that some or all of the members of the board approved or are interested in the transaction and that demand is futile because they will not sue themselves or contest their own acts. Although directors are unlikely to sue themselves, they may well take some action to palliate the consequences of poorly conceived acts, including their own. Directors want the venture to succeed, and if shown how they can improve its prospects, are likely to act. One mistake at the time of the initial decision does not imply that the member of the board opposes remedial action. Even when the "action" involves suit against some of their number, this does not disable the board. The ALI properly observes, *id.* at 70-71, that the board may appoint a minority of disinterested members to evaluate the demand and act for the corporation. In the extreme case in which all members are implicated, the board may expand its size and authorize the new members to act for the firm. Of course it may choose to do none of these things, but if so it will just decline the demand. Making a demand is cheap, *especially* so when the board is disabled from acting. Why prefer extended, costly litigation to the cheap and quick expedient of a demand?

2. The board may be determined not to sue. Perhaps by the time the judge comes to consider whether plaintiff should have made a demand, the defendant will have moved to dismiss the case on the merits. Any demand in such a case would be doomed to failure, and even at an earlier stage it may be transparent that the directors want nothing to do with litigation. This application of the "futility" exception has both a practical and a conceptual difficulty. The practical one is that it is difficult to tell in advance just what position the firm would take if asked; disputes about the demand requirement usually are resolved before the defendants plead to the merits. It is easy for the plaintiffs to *say* (and for the defendants to deny) that the board has a closed mind; it is much harder to tell who is right.

The conceptual difficulty is that even an adamant unwillingness to sue may reflect the merits. Boards ought not pursue silly or frivolous claims. So certain knowledge that the board is unwilling to authorize litigation may reflect only confidence that the case is feeble or injurious to the firm and other investors. Why should the plaintiffs be authorized to sue, and without so much as a request to the board, just because the complaint is all heat and no light? Once more the ALI hit the nail on the head when observing that a formulation of the futility rule that inquires whether a demand would prompt the board to correct a wrong "assumes that there is a wrong to be corrected. The director's antagonism to an action may well be justified and flow from a sound judgment that the action is either not meritorious or would otherwise subject the corporation to serious injury." *Id.* at 69. A decision not to file a weak lawsuit would be protected by the

business judgment rule, so it makes perfect sense to ask for the board's perspective.

3. A plaintiff may insist that even the independent directors are toadies, so that their judgment could not be respected. Perhaps they are friends of the putative defendants; perhaps they draw hefty directors' fees and fear loss of their offices if they authorize suit; perhaps they believe that the courts have no business supervising corporate affairs and would not authorize litigation no matter how meritorious (and no matter how little their regard for holding onto their offices). If demand is futile in fact for any of these reasons, then the board will say no with dispatch and the case may proceed. As we have broken the link between the demand and the standard of review, the plaintiff may employ this arsenal of arguments to argue that the decision not to sue ought not be respected; the board will stand on the business judgment rule. The court will resolve the question on the merits rather than trying to treat it as a procedural hurdle. Framing questions about the independence of the directors as exceptions to the demand requirement diverts attention from the real issues.

Kamen's complaint pursues all three of these arguments for futility and has all the weaknesses we have identified. Courts frequently say that considerations of this sort do not demonstrate futility. The district court's able opinion collects many of the holdings, 659 F.Supp. at 1161-63. We are in accord, as *Starrels* demonstrates.

Yet other cases, such as our opinions in *Nussbacher* and *Thornton*, accept the board's actual or anticipated unwillingness to sue as futility adequate to excuse

demand, greatly complicating the resolution of litigation. The line between "potential futility" and "real futility" is increasingly refined.

Recent cases in several circuits display impatience with the futility exception and have been creative in denying that a demand would be futile even when it is pellucid that the board is not about to authorize a suit. E.G., *Lewis v. Graves*, 701 F.2d 245 (2d Cir.1983); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir.1980); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.1973). Although none of these opinions dispenses with the exception altogether, the day is at hand – unless decisions of the Supreme Court bar the way.

Two decisions, *Doctor v. Harrington*, 196 U.S. 579, 25 S.Ct. 355, 49 L.Ed. 606 (1905), and *Susquehanna*, arguably adopt a futility exception to the demand requirement for purposes of pre-*Erie* general federal law. Although both of these cases speak favorably of a futility exception to the demand requirement, neither prevents the evolution of the federal common law.

Doctor raised the question whether the corporation should be aligned as a plaintiff or a defendant for purposes of diversity jurisdiction. The firm is a defendant to the extent the investor complains that it failed to bring suit; it is a plaintiff to the extent that the derivative suit may end in an order compelling the wrongdoers to pay money to the corporation. *Doctor* holds that the firm should be aligned as a defendant when the board is so hostile to the investors that demand would be futile; otherwise it should be aligned as a plaintiff. Many people (including the Supreme Court in *Susquehanna*, 213 U.S. at

449-50, 29 S.Ct. at 544) understood this as implying a futility exception to the demand requirement. Although this may have been a plausible inference, *Doctor* is no longer good law. It was overruled in all but name by *Smith v. Sperling*, 354 U.S. 91, 77 S.Ct. 1112, 1 L.Ed.2d 1205 (1957), which holds that in a derivative suit the corporation always should be aligned as a defendant for purposes of determining complete diversity. After *Sperling* "futility" is unimportant. When explaining why it would no longer use the board's refusal to sue as the basis of the alignment decision, the Court gave an explanation equally applicable to the futility exception to the demand rule in general: "To stop and try the charge of wrongdoing [in refusing to sue] is to delve into the merits. That does not seem to us the proper course. It is a time-consuming, wasteful exertion of energy on a preliminary issue in the case. The instant case is a good illustration, for it has been over eight years in the courts on the question of jurisdiction." 354 U.S. at 95, 77 S.Ct. at 1115.

Susquehanna interprets old Equity Rule 94, which codified the holding of *Hawes*. Rule 94 required demand, leaving no (apparent) room for exceptions. *Susquehanna* holds that the rule was not so inflexible. This *holding* is of no consequence; Rule 94 is no longer with us, having been amended many times in the course of the transformation to Rule 23.1. See *Fox*, 464 U.S. at 530-31 n. 5, 104 S.Ct. at 835-36 n. 5. But the discussion of futility, 213 U.S. at 447-52, 29 S.Ct. at 543-45, may be thought to establish a doctrine independent of the defunct equity rule. If this was the Court's meaning, the decision is nonetheless linked to its time. *Susquehanna* assumed that if the members of the board were implicated in the transaction, or

held financial interests in the party to be sued, they would be incompetent to act on a demand. Although that is so as a matter of corporate law, the court did not consider the possibility that a committee of independent directors could act on the demand. Not until the 1970s did courts hold that an independent committee could act on demands – and control litigation in the name of the corporation – even though a majority of the board was interested in the transaction. Development of the independent committee washed away the assumption on which the discussion in *Susquehanna* depends. The Court has never endorsed a “futility” exception to the demand requirement under current assumptions about the ability of committees to act for boards of directors, and given the statement in *Sperling* about the wastefulness of inquiries into futility we are confident it would not do so.

We conclude that precedent does not prevent us from holding that claims of futility should be tested by *making* the demand rather than by arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board’s decision is entitled to respect under state corporate law, which applies in light of the holding of *Burks*. See also *Petter v. Litton*, 308 U.S. 295, 306, 60 S.Ct. 238, 245, 84 L.Ed. 281 (1939); *Hill v. Wallace*, 259 U.S. 44, 61, 42 S.Ct. 453, 455, 66 L.Ed. 822 (1922); *United Copper*, 244 U.S. at 264, 37 S.Ct. at 510-11. As we have rejected *Zapata*, the making or failure to make a demand will not alter the business judgment standard that ordinarily applies to corporate decisions. Courts now may focus on the question whether the board’s actual decision should be given force, rather than on hypothetical inquiries. “Futility” is the only reason Kamen gives for not making

a demand on her claim under § 20(a). As this is an unsatisfactory reason, we agree with the district court's decision that the claim must be dismissed for failure to make a required demand.

Abolition of the futility exception calls into question our holdings in *Thornton* and *Nussbacher*. *Thornton* was a suit under ERISA, and the court extensively discussed the policies behind ERISA before deciding that demand would be futile. It may be that *Thornton*, like *Fox*, illustrates our category (c): Demand is not required when under substantive law the board may neither control nor prevent litigation. That question must be left for another day. *Nussbacher*, on the other hand, was founded squarely on the futility exception. The panel held that demand was excused because it was clear from the defendants' motion to dismiss the suit on the merits that demand would have been futile, 518 F.2d at 878-79. *Nussbacher* reasoned that because Rule 23.1 allows the plaintiff to plead reasons why demand is excused, it must follow that the futility of demand is an adequate excuse. In other words, *Nussbacher* treated Rule 23.1 itself as the source of the substantive requirements, a position we repudiated in *Starrels*, applying the rationale of *Burks*. Other decisions regularly hold that the board's defense of the suit on the merits does not justify failure to make demand. E.g., *Grossman v. Johnson*, 674 F.2d 115 (1st Cir.1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir.1978). Lest *Nussbacher* be thought to represent an independent assessment of the futility exception with continuing vitality, we now formally overrule that case.*

* Because this decision overrules an opinion of this court, it was circulated before release to all judges in active service. See Circuit Rule 40(f). No judge voted to hear the case in banc.

II

After *Fox* the demand requirement of Rule 23.1 does not apply to a claim under § 36(b). The Court held that § 36(b) creates a right of action that only the investor and the SEC may pursue. Because the mutual fund may not assert a claim against the investment adviser under § 36(b), the Court reasoned, Rule 23.1 – which applies only to suits “brought . . . to enforce a right of the corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it” – does not call for a demand on the directors to file suit. What is the point of dunning the directors, if under the statute they may not sue? Our holding with respect to the need for a demand under § 20(a) therefore does not affect the claim under § 36(b).

A

Judge Aspen dismissed the claim under § 36(b) on the basis of Magistrate Balog’s conclusion that Kamen is not an adequate representative of other investors in the Fund. Rule 23.1 requires adequacy: “The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.” Yet the very statement of the adequate-representation requirement repeats the theme that Rule 23.1 is limited to suits in which an investor seeks to enforce a *corporate* right. Rule 23.1 imposes hurdles, including both the pleading requirement and the adequate-representation requirement, before a court will strip the directors of their entitlement to manage the affairs of the corporation,

including their right to control the pursuit or compromise of its legal claims. *Fox* holds that a claim under § 36(b) is *not* a claim "of the corporation", and it follows that Rule 23.1 is inapplicable. Demand requirements and adequate-representation requirements go hand in glove. If the claim under § 36(b) is really the investor's *personal* claim, it is unimportant whether Kamen "adequately" represents other investors. Under the statute, she need represent no one.

Kemper relies on footnote 11 of *Fox*, 464 U.S. at 535 n. 11, 104 S.Ct. at 838 n. 11, which allows that a suit under § 36(b) is "undeniably 'derivative' in the broad sense of that word", because the fiduciary obligation runs to the mutual fund, which will receive any remedy. True enough, but it is of no assistance to defendants. Rule 23.1 does not ask whether a suit is derivative "in the broad sense of that word". It asks whether the suit seeks to enforce a right of the corporation, "the corporation . . . having failed to enforce a right which may properly be asserted by it". *Fox* holds that the claim under § 36(b) is not one the corporation may assert. It therefore establishes that Rule 23.1 does not apply, period. The opinion could hardly be clearer. At pages 528, 535 n. 11, 104 S.Ct. at 834, 838 n. 11, and again in stating the holding at 542, 104 S.Ct. at 841, the court quotes this language of Rule 23.1 and observes that § 36(b) litigation does not fall within the domain of the rule. Lest there be any doubt, the last sentence reads:

It follows that Rule 23.1 does not apply to an action brought by a shareholder under § 36(b) of

the Investment Company Act and that the plaintiff in such a case need not first make a demand upon the fund's directors before bringing suit.

464 U.S. at 542, 104 S.Ct. at 841. Kamen filed a suit under § 36(b), and Rule 23.1 therefore "does not apply". In *Fox* that meant no demand; here it means no need for adequate representation. See also *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir.1953) (similar conclusion with respect to the short-swing-profit-recovery provision of § 16(b) of the Securities Exchange Act of 1934).

If Rule 23.1 does not require adequate representation, defendants maintain, then the due process clause of the fifth amendment must. Due process requires adequate representation, though, only when the plaintiff is *representing* someone else. A judgment in a class action will bind persons who are not before the court. Before resolving the legal entitlements of missing persons, the court must ensure that they have an effective voice. *Hansberry v. Lee*, 311 U.S. 32, 41-42, 61 S.Ct. 115, 117-18, 85 L.Ed. 22 (1940). Kamen represents no one other than herself. *Fox* establishes that the right at stake is personal; she does not need the approval of the court or other investors to pursue it. Doubtless other investors are interested in the result, yet many suits affect the status of others as a practical matter without triggering a constitutional requirement of "adequate representation".

Rules 19 and 24 are designed for such cases. Rule 19 allows and sometimes requires the joinder of persons who will be affected by a judgment; Rule 24 allows intervention. Defendants do not maintain that Rule 19 requires the joinder of other investors. Rule 24 may allow them to intervene on the other side to argue for or against

Kemper's management fees. *Bethune Plaza, Inc. v. Lumpkin*, 863 F.2d 525, 531-34 (7th Cir.1988). None has done so, undoubtedly because investors who support the current fee structure believe that they already have adequate champions: Kemper and the Fund. What is more, a judgment against the defendants requiring a reduction in the level of fees would not "bind" other investors any more than a judgment in a contract or tort suit "binds" the investors and employees of the firm required to pay damages. If the court should deem the fees excessive, and the Fund then cut back on services, shareholders may take their money elsewhere. That would injure the Fund and Kemper, which as parties represent themselves. It might also reduce the consumers' surplus of the investors (the value they place on the Fund's services, less the price they pay), but such an indirect consequence does not require either actual or vicarious representation in the litigation. See *O'Bannon v. Town Court Nursing Center*, 447 U.S. 773, 788-89, 100 S.Ct. 2467, 2476-77, 65 L.Ed.2d 506 (1980).

B

At all events, Kamen is no less adequate a representative than are most plaintiffs in class actions. Securities actions, like many suits under Rule 23, are lawyers' vehicles. Investors diversify their holdings, so it is no surprise that Kamen, like most plaintiffs in securities cases, does not hold very much stock in the defendants and has delegated the investigation and prosecution of the suit to counsel. Class actions are valuable precisely because they allow the vindication of claims too small to prosecute individually but worth litigating in the aggregate. See *In*

re *American Reserve Corp.*, 840 F.2d 487 (7th Cir.1988). When defendants' counsel took Kamen's deposition and learned that she knew little about either the Fund or the case and had given counsel free reign, they learned only that this case fits the norm. Securities markets function efficiently because of the division of labor; legal markets also rely on specialization. Kamen did not need to immerse herself in the mutual fund business to qualify as a plaintiff. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 86 S.Ct. 845, 15 L.Ed.2d 807 (1966); *Lewis v. Curtis*, 671 F.2d 779, 788-89 (3d Cir.1982). Counsel to whom Kamen entrusted the litigation – perhaps more accurately, who found Kamen to wage the litigation – is a specialist in the field, having argued and won *Fox* in the Supreme Court. There can be no doubt that Kamen's champion will advocate the claim vigorously and skillfully.

Magistrate Balog's conclusion that Kamen has only a private grievance misses the point. Kamen is not trying to get even because she bears a grudge – say, because a ~~member~~ of the Fund's board trampled her petunias. She seeks a higher rate of return on her investment. So do all other shareholders in the Fund. It may well be that most other shareholders believe that the Fund's special services are worth the 0.2% cost, but shareholders have a common interest in ensuring that the Fund pays Kemper no more than the extra services are worth. Commonality of interest is the essence of adequate representation. *Sosna v. Iowa*, 419 U.S. 393, 403, 95 S.Ct. 553, 559, 42 L.Ed.2d 532 (1975). If the services make a 0.2% premium fee "excessive", the defendants will prevail on the merits. If the services do not justify the incremental fee, then all shareholders will gain from a decision.

Given that Kamen and other investors win or lose together, the adequacy of her representation (more realistically, of her lawyer's) matters if the suit is strong. Suppose the Fund has a well-grounded claim against Kemper for \$40 million in excessive fees. A feeble litigant, or one willing to sell out for satisfaction of her personal claim, would injure other investors in the Fund by extinguishing the claim against Kemper without producing its full value for the Fund. Other investors therefore could be worried that the first one to step forward and sue will be insufficiently vigorous, or have divided loyalties. No such investor has appeared to complain that Kamen will do too little for them, and neither the Fund nor Kemper seems worried that Kamen will under-prosecute this suit. Why is it that the *defendants* insist that the plaintiff is a poor representative of the other stockholders? Perhaps defendants fear that Kamen will be too vigorous?

Defendants' principal fear is not of inadequate representation but of legal error – that a court playing rate regulator may think the fees excessive even when they are not. Such a mistake would injure all investors, and the injury would fall more heavily on investors other than Kamen who use the sweeps and redemption services the Fund provides. Kamen would find other money market funds suited to her passive investment strategy; active investors would be especially aggrieved by a cutback in services. In this sense, even though Kamen's interests are the same as those of other investors – all want the Fund to pay no more than the market price for the services Kemper renders – Kamen has less to fear from an error and therefore is not the optimal champion. Still, such differences in incentives pervade class actions. Even if the

members of the class were perfectly homogeneous (they never are), the representative's small stake might lead her to settle for too little or to press arguments that favored her position (or her attorney's) at the potential expense of those she represents. See Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. Legal Studies 47 (1975); Andrew Rosenfield, *An Empirical Test of Class-Action Settlement*, 5 J. Legal Studies 113 (1976). Agency costs of this kind, even when coupled with differential sensitivity to error costs, are not the same as concrete conflict of interest between the "representative" and other members of the class. They inhere in representative actions. The real bogies, the 'costs of defense and the risk of error, haunt all litigation. False positives and the potential for self-serving conduct are endemic to the system under § 36(b); the costs of legal error in regulating prices are attributable to the existence of § 36(b) and not to the selection of Kamen as a plaintiff.

Although the investors by majority vote approved Kemper's fees in 1986, the vote was not unanimous. Of the 5.3 billion shares of the Fund's money market portfolio in 1986, 2.97 billion were voted at the meeting (almost all by proxy). Approximately 2.44 billion were voted for the management agreement, 364 million against, and 169 million abstaining. The contract was ratified, then, by 82% of the shares present at the meeting, although only 46% of the outstanding shares. These figures do not suggest that Kamen is in a teensy minority; she had as of 1986 the company of the holders of 364 million shares of the Fund. Section 36(b)(2) provides that investors' approval of a management fee should inform the court's judgment on the merits; it does not imply that approval

forecloses suit by one of the dissenters – if it did, § 36(b) would be dead, for *all* fees challenged under the statute have been approved by the investors at one or another time. So, too, it is not dispositive that none of the other investors has intervened to support Kamen's suit. Many a class action proceeds with a single representative; conservation on the number of litigants is a virtue of the device. Even if this were a case in which the plaintiff must represent others "adequately", then, Kamen would be a proper plaintiff.

III

Because the action may proceed under § 36(b), we need to decide whether Kamen is entitled to a jury trial in the event there are disputed issues of material fact. Judge Nordberg held not, following *In re Evangelist*, 760 F.2d 27 (1st Cir.1985), *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45 (2d Cir.1987), and *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 414 (2d Cir.1989). These opinions hold that the action authorized by § 36(b) is not a "suit[] at common law" within the meaning of the seventh amendment because the statute creates a fiduciary duty and recovery "shall in no event exceed the amount of compensation or payments received from [the] investment company". § 36(b)(3). A combination of fiduciary duty with a remedy of cancellation and restitution is traditionally equitable.

Novel statutes such as § 36(b), establishing requirements and procedures that *Fox* repeatedly called "unique", do not fit well into a constitutional framework

requiring the rights to jury trial as of 1791 to be "preserved". Federal courts abolished the distinction between law and equity with the adoption of the Rules of Civil Procedure in 1938, and changes in both the nature of legal rights and the preferred remedies make it difficult to reconstruct what our forbears would have seen as "common law". See Douglas G. Baird, *The Seventh Amendment and Jury Trials in Bankruptcy*, 1989 Sup.Ct. Rev. 261. No rights comparable to those of § 36(b) existed two centuries ago; the closest equitable action dealt with corporate "waste" and not with determining whether prices are reasonable. Although enforcing fiduciary duties was equitable in English practice, awarding damages was a job for a common law court. Squeezing a hybrid action into one category or the other is bound to cause friction. Recognizing that no answer can be wholly satisfactory, and not wanting to add unnecessarily to the clutter of opinions on the subject, we adopt both the holding and rationale of *Evangelist*.

One case postdating the First and Second Circuits' decisions calls for comment. *Teamsters Local No. 391 v. Terry*, ___ U.S. ___, 110 S.Ct. 1339, 108 L.Ed.2d 519 (1990), holds that a suit alleging that a union breached its duty of fair representation, and requesting damages measured by the amount of back pay, is "at common law" for constitutional purposes and so allows either side to demand a jury. The Court rejected an argument that the foundation of the suit on a breach of the union's fiduciary duty to its members was sufficient to render it "equitable". Even the fillip that the remedy would be measured by the amount of pay lost, a yardstick from the courts of equity, did not

suffice. *Terry* appears to call into question the foundation for *Evangelist* and similar holdings about § 36(b).

Although any prediction is hazardous, we conclude that the Court would think an action under § 36(b) equitable under the analysis it used in *Terry*. Seven Justices accepted the proposition, central to cases such as *Evangelist*, that "an action by a trust beneficiary against a trustee for a breach of fiduciary duty" is equitable because it was "within the exclusive jurisdiction of the courts of equity" in 1791. 110 S.Ct. at 1346 (plurality opinion); see also *id.* at 1355 (Kennedy, J., dissenting). The investment adviser is not a "trustee", and the relation between fund and adviser is contractual rather than one in which the beneficiary of the trust lacks authority to choose the trustee; still, the statute creates a fiduciary duty and enforces it with a remedy (disgorgement) common in trust cases.

The analogy between the union's duty and a trustee's broke down in *Terry* because the union was supposed to be enforcing a contract, and the claim against the union depended on proof that the employer broke its contract. The remedy, although measured by pay lost, came from the union rather than the employer, which made it look more like damages than restitution. An action under § 36(b), quite unlike the action for a breach of the duty of fair representation, is one to annul a contract rather than to enforce it. Reformation or cancellation of a contract was equitable in 1791 and until the distinction between law and equity broke down in this century. Restitution under § 36(b) comes from the party that received the benefits, which further separates this case from *Terry*. Four different opinions in *Terry*, advocating four different approaches to the constitutional question, render parlous

any predictions. Nonetheless, the combination of a fiduciary duty with a restitutionary remedy in § 36(b) continues to put this statute on the equitable side of the constitutional line.

The judgment of the district court is affirmed in part, reversed in part, and remanded for further proceedings on the claim under § 36(b).

App. 65

District Court Memorandum Opinion and Order
dated February 2, 1987

Jill S. KAMEN, Plaintiff,

v.

KEMPER FINANCIAL SERVICES, INC., and
Cash Equivalent Fund, Inc., Defendants.

No. 85 C 4587.

United States District Court,
N.D. Illinois, E.D.

Feb. 2, 1987.

MEMORANDUM OPINION AND ORDER

NORDBERG, District Judge.

The plaintiff, Jill Kamen, is a shareholder in Cash Equivalent Fund, Inc. ("the Fund"), a money market mutual fund managed and administered by Kemper Financial Services, Inc. ("KFS"). Plaintiff instituted this shareholder's derivative action pursuant to the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* ("ICA" or "the Act"), challenging the fees charged by KFS for managing and administering the Fund. She alleges that KFS solicited a misleading proxy in violation of § 20(a) of the Act, 15 U.S.C. § 80a-20(a), and that KFS' excessive fees constitute a breach of its fiduciary duty in violation of § 36(b) of the Act. 15 U.S.C. § 80a-35(b).¹ Defendants move to dismiss plaintiff's § 20(a) claims for failure to state a cause of action and for failure to make a

¹ This court has jurisdiction pursuant to § 44 of the Act, 15 U.S.C. § 80a-43.

demand on the Board of Directors as required by Fed.R.Civ.P. 23.1; and to strike plaintiff's jury demand. For the following reasons, the court grants the motions to dismiss and to strike the jury demand.

Factual Allegations

The facts, as alleged in the complaint,² are as follows. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the ICA. It invests in a range of short-term money market instruments with maturities of one year or less. The Fund commenced operations on March 16, 1979, and, as of April 23, 1985, its total assets were approximately \$4.683 billion.

KFS has acted as the Fund's investment adviser, manager, primary administrator and underwriter since the Fund's inception. In exchange for its services, KFS receives monthly fees paid under two separate agreements. The investment management agreement provides for an investment management fee calculated at the annual rate of .22 of 1% of the first \$500 million of the combined average daily net assets of the portfolios managed by KFS, .20 of 1% of the next \$500 million, .175 of 1% of the next \$1 billion, .16 of 1% of the next \$1 billion and .15 of 1% of average daily net assets of such portfolios over \$3 billion. The administration, shareholder

² On a motion to dismiss, the court must accept all well pleaded facts as true, and must make all reasonable inferences in the light most favorable to the plaintiff. *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102, 2 L.Ed.2d 80 (1957); *City of Milwaukee v. Saxbe*, 546 F.2d 693, 704 (7th Cir.1976).

services and distribution agreement ("administration agreement") provides for an annual fee, payable monthly, on a basis of .33% of the first \$500 million of average daily net assets, .30% of the next \$500 million, .275% of the next \$1 billion, .265% of the next \$1 billion, and .25% of average daily net assets over \$3 billion.

The Fund has experienced tremendous success in attracting shareholder funds in the past several years, which has caused a significant increase in the total fees payable to KFS under the two separate agreements. For the fiscal year ended July 31, 1984, the Fund paid KFS nearly \$20 million in fees.³

The essence of plaintiff's complaint is that these fees are excessive, given the nature of the fund and the services performed by KFS. Plaintiff alleges that, unlike other mutual funds, the management of the assets of a money market fund "does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts [because] the assets of the Fund are . . . invested in a relatively concentrated manner in fixed income obligations maturing in one year or less." (Compl. ¶9).⁴ Despite the huge growth

³ Kamen filed a supplemental complaint on December 8, 1986. This complaint alleges that the Fund's Board of Directors amended KFS' administration agreement in November of 1986 to substantially increase the fees paid to KFS.

⁴ Paragraph 14 alleges:

Because of the limited number, nature and variety of the Fund's investments, the investment decisions of

(Continued on following page)

of the Fund and the manner in which it is serviced, the fee structure has remained the same since December 1, 1981, when the fees were increased by virtue of the administration agreement. According to Kamen, the increased compensation paid to KFS resulting from the enormous increase in Fund assets is disproportionate to the services rendered by it. These allegations form the basis of Kamen's excessive fee claim under § 36(b) of the Act, 15 U.S.C. § 80a-35(b).

Kamen also alleges that KFS violated § 20 of the ICA, 15 U.S.C. § 80a-20, which proscribes the solicitation of misleading proxies in connection with a security of a registered investment company.⁵ In addition to the Fund,

(Continued from previous page)

the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and 'turning over' money market instruments with a limited number of institutions. The incremental cost to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.

⁵ 15 U.S.C. § 80a-20(a) provides in pertinent part:

It shall be unlawful for any person, by use of the mails or any means of instrumentality of interstate

(Continued on following page)

KFS also acts as an investment manager to the Kemper Money Market Fund, Inc. ("MM"), a money market fund which is similar to the Fund in size, number of shareholders, and investment objective. MM and the Fund have some common directors, and require substantially the same services from KFS. According to Kamen, despite this similarity in size and objective, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients.⁶

Kamen further alleges that, on or about September 12, 1984, KFS caused a proxy statement to be distributed to the shareholders for the annual meeting of shareholders scheduled for November 8, 1984. One of the purposes of the meeting was to obtain shareholder

(Continued from previous page)

commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect to any security of which a registered investment company is the issuer in contravention of such rules and regulations of the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 20a-1 renders the rules and regulations promulgated by the SEC pursuant to § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n, applicable to misleading proxy claims under § 20(a) of the ICA. 17 C.F.R. 270.20a-1.

⁶ Kamen alleges that in the Fund's expenses in the year ended July 31, 1984 were .72% of its average net assets, while MM's expenses were only .53% of its average net assets. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM. (Compl. ¶12).

approval for the continuance of the investment management agreement with KFS. The proxy statement seeking shareholder approval of the investment management agreement compared the fees that KFS received from other investment companies to those paid by the Fund. Kamen alleges that, although the proxy correctly compared the services rendered to the Fund to those rendered to MM, it "misleadingly" described MM's fees as "a maximum fee of .50 of 1% of the first \$215 billion, with lesser rates on additional assets." This "misleading" description gave the false impression that MM's fees were as high or higher than those paid by the Fund, when KFS knew that the opposite was actually true. The proxy solicitation was successful, and KFS obtained shareholder approval for continuation of its investment management agreement with the Fund.

As the above allegations clearly demonstrate, the thrust of Kamen's § 20(a) claim is that KFS disseminated misleading proxies in order to obtain continued shareholder approval for allegedly exorbitant fees. KFS' motion to dismiss concerns only the § 20(a) claims. It urges dismissal of this claim on two grounds: first, because Kamen failed to make a demand on the Fund's directors, as required by Fed.R.Civ.P. 23.1; and second, because § 36(b) of the Act provides the exclusive remedy for excessive fees. For the following reasons, the court finds that, although the complaint properly alleges a cause of action under § 20(a), it must be dismissed because Kamen failed to comply with the demand requirements of Rule 23.1.

Claims Under § 20 of ICA

KFS argues that ¶13 of the complaint, which alleges violations of § 20(a) of the ICA, 15 U.S.C. § 80a-20(a), must be dismissed because § 36(b) provides the exclusive remedy for shareholder claims alleging excessive fees. Section 20(a) of the ICA forbids the dissemination of misleading information in proxies solicited from mutual fund shareholders. Section 36(b) of the Act, which was passed in 1970,⁷ authorizes a shareholder's suit to recover excessive fees from a fund's investment adviser. Congress added this section in order to remedy the fact that the Act, as originally passed, failed to "provide any mechanism by which the fairness of management contracts [between a fund and its adviser] could be tested in court." S.Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* 1970 U.S.Code Cong. & Admin.News 4897, 4901. Section 36(b) creates a fiduciary duty on the part of the adviser "with respect to compensation for services or other payments paid by the fund . . . to the advisers," *id.*, and authorizes shareholders to sue for breach of that fiduciary duty. *See generally Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 104 S.Ct. 831, 78 L.Ed.2d 645 (1984).

Prior to the passage of § 36(b), the Second Circuit had recognized an implied cause of action under the ICA for misleading proxy statements. *See Brown v. Bullock*, 194 F.Supp. 207, 231-34 (S.D.N.Y.), *aff'd*, 294 F.2d 415, 420-21 (2d Cir.1961).⁸ It continued to recognize an implied cause

⁷ Section 20(a) was part of the original Investment Company Act passed in 1940.

⁸ All of the cases discussing an implied right of action under § 20(a) have arisen in the Second Circuit.

of action for § 20(a) claims unrelated to allegations of excessive fees after the passage of the 1970 amendments. *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934, 98 S.Ct. 421, 54 L.Ed.2d 293 (1977); *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir.1976); *Rosenfeld v. E.R. Black*, 445 F.2d 1337 (2d Cir. 1971). In *Fogel v. Chestnutt Corp.*, 668 F.2d 100, 112 (2d Cir.1981), *cert. denied*, 459 U.S. 828, 103 S.Ct. 65, 74 L.Ed.2d 66 (1982), however, the court noted in dictum that § 36(b) may constitute a shareholder's exclusive remedy for his claims of excessive fees.

Although some district courts seized on the language in *Fogel* to disallow implied claims for excessive fees under the ICA,⁹ a recent decision has recognized a claim under § 20(a) of the ICA in a situation involving facts very similar to the case at bar. In *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 622 F.Supp. 169 (S.D.N.Y. 1985), the plaintiff-shareholder alleged that the management fee paid to the fund's adviser was excessive (36(b) claim) and that the defendants violated § 20(a) because the proxies soliciting shareholder approval of the management contract were misleading. The plaintiff sought repayment of the excessive fees under the § 36(b) claim, and sought profits and/or reimbursements for the amounts paid under the agreements obtained through the misleading

⁹ See, e.g., *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F.Supp. 1038, 1067 (S.D.N.Y.1981), *aff'd*, 694 F.2d 923 (2d Cir.1982), *cert. denied*, 461 U.S. 906, 103 S.Ct. 1877, 76 L.Ed.2d 808 (1983) ("*Gartenberg I*"); *Tarlov v. Paine Webber Cash Fund, Inc.*, 559 F.Supp. 429, 437 (D.Conn.1983).

proxy. *Schuyt*, 622 F.Supp. at 171. The defendants sought dismissal of the § 20(a) claim on the grounds that § 36(b) provided the exclusive remedy for plaintiffs' excessive fee claims.

The court rejected Rowe Price's argument that Schuyt's § 20(a) claim was "'an excessive fee claim dressed in slightly different clothes.'" *Id.* at 173-74. It noted:

Count III of the Third Amended Complaint does not allege *solely* that advisory fees paid by the Fund to Price Associates were excessive. The § 20(a) claim raised in Count III advances distinct factual allegations of material non-disclosures in particular proxy statements, and seeks legal and equitable relief beyond the mere recapture of excessive fees. Because it cannot fairly be characterized as a claim that alleges *solely* a breach of fiduciary duty arising from excessive compensation paid to an investment adviser, plaintiff's § 20(a) claim does not fall within the narrow category of claims that the Second Circuit panel in *Fogel v. Chestnutt*, *supra*, thought might properly be brought only under § 36(b).

Id. at 174 (emphasis in original). In the present case, Kamen has not denominated her claims in separate counts.¹⁰ However, it is clear from the pleadings that she

¹⁰ In this respect, Kamen's complaint fails to satisfy the requirements of Fed.R.Civ.P. 10(b), which requires "that each claim founded upon a separate transaction or occurrence . . . shall be stated in a separate count."

seeks damages for the alleged § 20(a) violation and reimbursement of excessive fees for the § 36(b) claim. The factual allegations of misleading proxy statements are distinct from the fiduciary breach allegations. Both address a distinct form of culpable conduct separately redressable under the ICA. Following *Schuyt*, the court finds that Kamen should be able to pursue both claims in this lawsuit.

The Supreme Court recently decided a similar issue in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). In that case, the plaintiff alleged that defendants issued a misleading registration statement, and filed suit under § 10(b) of the Securities Exchange Act of 1934 and § 11 of the Securities Act of 1933. The defendants sought dismissal of the implied action under § 10(b) on the grounds that § 11 provided the exclusive remedy for misrepresentations relating to registration statements. The Supreme Court noted that these two provisions involve distinct causes of action, and were intended to address different wrongdoings. Thus, although the evidence supporting the two claims might overlap, this fact, in and of itself, was insufficient to preclude plaintiff from pursuing both claims. 495 U.S. at 381, 103 S.Ct. at 686.

This analysis applies with equal force to KFS' argument that § 36(b) provides the sole remedy for excessive fees. Section 20(a) was enacted in order to ensure complete and adequate disclosures in proxy materials solicited from mutual fund shareholders. Patterned after § 14 of the Securities Exchange Act of 1934, it prohibits dissemination of misleading proxies. In order to recover for a violation of this section, the plaintiff must establish "a

substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of the information available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2133, 48 L.Ed.2d 757 (1976). In contrast, a plaintiff in a § 36(b) suit must prove a breach of fiduciary duty on the part of the investment adviser. 15 U.S.C. § 80a-35(b)(1). Proof of misrepresentations may assist the plaintiff in his burden of proof, but a plaintiff need not establish the existence of misrepresentations in order to prevail on a § 36(b) claim. To prove a § 36(b) violation, the plaintiff must demonstrate that the adviser charges a fee "that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms length bargaining." *Gartenberg I*, 694 F.2d at 928. Thus, although a violation of § 20(a) may be relevant to a § 36(b) claim, it clearly exists independent of that claim. See *Schuyt*, 622 F.Supp. at 176-77.¹¹ Following *Huddleston*, there is no reason to carve out an exception to the well-recognized implied cause of action from misleading proxy statements under § 20(a) of the ICA.

¹¹ The court disagrees with KFS's argument that allowing § 20(a) claims in the context of excessive fee suits would thwart the intent of Congress when it passed § 36(b). According to KFS, allowance of a § 20(a) claim would undermine the procedural restrictions contained in § 36(b). What KFS fails to acknowledge is that a § 20(a) claim exists independent of a § 36(b) claim, and involves different elements of proof. Not all § 36(b) claims involve misleading proxies, and a plaintiff needs a misrepresentation in a proxy statement if she wishes to proceed under § 20(a).

Contrary to KFS' argument, the legislative history of the passage of § 36(b) does not evince a Congressional intent to preclude other suits to recover excessive fees based on wrongdoings prohibited by other sections of the ICA. In *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 378-79, 102 S.Ct. 1825, 1839, 72 L.Ed.2d 182 (1982), the Court held that when Congress amends a pre-existing law, the proper inquiry is not whether Congress intended to create a private remedy to supplement the express remedy, but rather, whether "Congress intended to *preserve* the pre-existing remedy." (emphasis supplied). Prior to the passage of § 36(b), the courts had recognized an implied right of action for claims related to the procurement of an advisory contract which permits excessive fees. *Brown v. Bullock*, 294 F.2d 415 (2d Cir.1961). Cf. *J.I. Case v. Borak*, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964) (recognizing an implied cause of action under § 14 of the Securities Exchange Act of 1934). This court agrees with the *Schuyt* court's conclusion that "nothing in the statute or legislative history indicates that Congress intended to preclude a mutual fund shareholder from joining a § 36(b) claim for excessive fees with claims for breach of other fiduciary duties or for other distinct violations of the ICA." *Schuyt*, 622 F.Supp. at 177 (footnote omitted). See *Krome v. Merrill Lynch & Co., Inc.*, 637 F.Supp. 910, 917-20 (S.D.N.Y. 1986); Note, *Implied Private Rights of Action under the Investment Company Act of 1940*, 40 Wash. & Lee L.Rev. 1069, 1085-86 (1983).

KFS relies primarily on *Gartenberg I* to support its argument that § 36(b) provides the exclusive remedy for excessive fee claims. *Gartenberg I* provides little support for the argument that § 20(a) claims cannot be joined with

claims under § 36(b). In *Gartenberg I*, the plaintiff did not raise the issue of alleged violations of § 20(a) until after the court had completed a bench trial on his § 36(b) claims. This district court dismissed this belated claim because the alleged misstatements were not misleading. 528 F.Supp. at 1066. It added, "[i]n any event, . . . § 20(a) of the Act w[as] not intended to and do[es] not establish a private right of action in the context of a claim such as here for recovery of compensation under § 36(b)." *Id.* at 1067. On appeal, the Second Circuit affirmed the District Court's findings with respect to Gartenberg's § 36(b) claims. 694 F.2d at 930-33. The court also affirmed the district court's dismissal of the belated § 20(a) claims because they were not properly before the district court for adjudication. It added, "[i]n any event, for the reasons already expressed by us and the additional reasons stated by the district court in its discussion of these additional claims, . . . they are meritless." 694 F.2d at 934.

The *Gartenberg* plaintiffs filed a second case after the Second Circuit issued its decision in *Gartenberg I*. *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 573 F.Supp. 1293 (S.D.N.Y.1983), *aff'd*, 740 F.2d 190 (2d Cir.1984) ("*Gartenberg II*"). In *Gartenberg II*, the plaintiffs raised claims under both § 20(a) and § 36(b). The case was assigned to the same district judge who tried *Gartenberg I*. It is noteworthy that this judge tried both claims, without mention of his statement in *Gartenberg I* that § 36(b) might preclude § 20(a) claims based on misleading proxies used to authorize excessive fees. *Gartenberg II*, 573 F.Supp. at 1307 (discussing merits of § 20(a) claim). The *Gartenberg II*

affirmance also fails to refer to the court's earlier statement that § 36(b) precludes § 20(a) claims in this type of case.

In *Schuyt*, the court noted the same distinction between the treatment of § 20(a) claims in *Gartenberg I* and *Gartenberg II*. It concluded:

[The District Court's] strikingly different treatment of the two § 20(a) claims raised in *Gartenberg II* strongly suggests that his rejection at [the] § 20(a) claim in *Gartenberg I* and *II* resulted from the defects peculiar to that claim and not from a defect generic to all § 20(a) claims joined with a claim for excessive fees.

Schuyt, 622 F.Supp. at 176.¹² This court agrees that the court's comments in *Gartenberg I* must be viewed in the context of that case. Given the Second Circuit's acknowledgment of § 20(a) claims after *Gartenberg I*, the court finds that this case provides scant support to KFS' argument that § 20(a) claims can never be raised in connection with a § 36(b) suit for excessive fees.

For the reasons set forth above, the court finds that the passage of § 36(b) does not preclude a claim under § 20(a) which alleges that the management contract was secured through a misleading proxy. Therefore, the court denies KFS' motion to dismiss Kamen's § 20(a) claim for failure to state a cause of action.

¹² The court notes that the Second Circuit has issued another decision subsequent to *Gartenberg II* which allowed § 20(a) claims without mention of the possible limitation imposed by § 36(b). See *Meyer v. Oppenheimer Management Corp.*, 764 F.2d 76 (2d Cir.1985).

Rule 23.1's Demand Requirement

This complaint was filed as a shareholder's derivative action in which Kamen seeks to sue on behalf of the Fund to recover excessive fees allegedly paid to KFS. Rule 23.1, which governs derivative actions, provides:

In a derivative action brought by [a] shareholder . . . to enforce a right of a corporation, . . . the corporation having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors, . . . and the reasons for his failure to obtain the action or for not making the effort.

In *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 104 S.Ct. 831, 841, 78 L.Ed.2d 645 (1984), the Supreme Court held that Rule 23.1's demand requirement is inapplicable to shareholder suits challenging excessive advisory fees under § 36(b). KFS acknowledges that Kamen's § 36(b) claims cannot be dismissed for noncompliance with Rule 23.1; however, it urges the court to dismiss the § 20(a) claims, which are not implicated by the *Fox* decision, because Kamen failed to make a demand on the Fund's Board of Directors in accordance with Rule 23.1.

The purpose of Rule 23.1's demand requirement is to notify directors of a potential claim, so that they may investigate it and pursue intracorporate remedies before a court intervenes at a shareholder's request. *Thornton v. Evans*, 692 F.2d 1064, 1080 (7th Cir.1982); *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D. Ill.1981). The demand requirement stems from the recognition that "derivative actions

brought by minority stockholders could, if unconstrained, undermine the basic principle of corporate governance that the decisions of a corporation – including the decision to initiate litigation – should be made by the board of directors or the majority of shareholders.” *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 104 S.Ct. 831, 836, 78 L.Ed.2d 645 (1984). -Rule 23.1’s limitations are “designed to limit the use of the [shareholders’ derivative suit] to situations in which, due to an unjustified failure of the corporation to act for itself, it [is] appropriate to permit a shareholder ‘to institute and conduct litigation which usually belongs to the corporation.’ ” *Id.*, citing *Hawes v. City of Oakland*, 104 U.S. (14 Otto) 450, 460, 26 L.Ed 827 (1882).

The rationale underlying Rule 23.1’s demand requirement is two-fold: first, the courts presume that management is in a superior position to assess the merits of a particular claim; and second, assuming the claim is valid, the corporation may possess superior financial resources with which to pursue the litigation. *Lewis v. Anselmi*, 564 F.Supp. 768, 771 (S.D.N.Y.1983); *Abrams v. Mayflower Investors, Inc.*, 62 F.R.D. 361, 369 (N.D.Ill. 1974). The “futility” exception to the demand requirement recognizes that there are circumstances where a demand would be a useless gesture, given the relationship between the board of directors and the alleged illegal transaction. Accordingly, Rule 23.1 permits a court to excuse the failure to make a demand if the plaintiff alleges with particularity specific circumstances which indicate that the directors would have ignored her complaints or refused to take any action on them. *See generally Nussbacher v. Continental Illinois National Bank & Trust Co.*

of Chicago, 518 F.2d 873, 875 (7th Cir.), *cert. denied*, 424 U.S. 928, 96 S.Ct. 1142, 47 L.Ed.2d 338, (1976) (plaintiff's failure to make formal demand excused because plaintiff was told directly that the directors would not assist her in any way); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264-65 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973) (allegations of self-interest or bias may excuse demand); *Untermeyer v. Fidelity Daily Income Trust*, 79 F.R.D. 36, 42 (D. Mass.), *vacated*, 580 F.2d 22 (1st Cir.1978) (plaintiff should allege facts which show an "unmistakeable antagonism between the trustees and the corporate interests").

It is undisputed that Kamen failed to make a demand on the Fund's Board of Directors. Although the original complaint did not provide any excuse for this non-compliance with Rule 23.1, Kamen has corrected this error by filing an amended complaint which alleges that resort to the Fund's Board of Directors was not attempted because it would have been futile. Paragraph 17 of the Amended Complaint alleges the following facts in support of Kamen's futility claim:

(a) With respect to the claims asserted under § 36(b) of the Act, no such demand is required;

(b) The board of directors of the Fund consists of ten members. Of those, three are "interested" as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called "non-interested" directors currently receive aggregate remuneration of

approximately \$300,000 a year for serving as directors of the Fund and of all of the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;

(c) The proxy statement referred to in paragraph 13 above stated: "The accompanying proxy is solicited by the Board of Directors of the Fund . . . ", and indeed, the directors did vote, without dissent, to distribute the proxy statement to Fund shareholders. Any suit, such as the instant suit, brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund;

(d) Requiring the plaintiff to make a demand on the Fund or its directors to institute or prosecute this action would be futile. It would be tantamount to asking the directors to sue themselves. Moreover, were the directors to accept such an invitation and institute an action, the prosecution of the action would be in hostile hands inimical to its success;

(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;

(f) In responding to the original complaint, the Fund, both in its answer and motion to dismiss, has sought the dismissal of the complaint on substantive grounds;

(g) Under all of the circumstances present in this case, application of a demand requirement would be inconsistent with the federal

policy underlying § 20 of the Investment Company Act.

The court finds that, although subsection (a) correctly explains the applicability of Rule 23.1 to the § 36(b) claim, subsections (b) through (g) are insufficient to satisfy the pleading requirements of Rule 23.1.

Rule 23.1 requires a plaintiff to allege facts excusing her failure to make a demand "with particularity." This requirement " 'represents a deliberate departure from the relaxed policy of notice pleading promoted elsewhere in the Federal Rules.' " *Grossman v. Johnson*, 89 F.R.D. 656, 659 (D. Mass.1981), *affd.* 674 F.2d 115 (1st Cir.), *cert. denied*, 459 U.S. 838, 103 S.Ct. 85, 74 L.Ed.2d 80 (1982) (quoting *Heit v. Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977)). See also *Kaufman v. Kansas Gas & Electric Co.*, 634 F.Supp. 1573, 1578 (D.Kan.1986) (holding plaintiff to strict pleading requirements); *Atkins v. Tony Lama Co., Inc.*, 624 F.Supp. 250, 255 (S.D. Ind.1985) (conclusory allegations of "futility" insufficient); *Kaufman v. Safeguard Scientifics, Inc.*, 587 F.Supp. 486, 489 (E.D. Pa.1984) (Rule 23.1 requires "meticulous specification" of the facts surrounding plaintiff's failure to make a demand). As the following discussion illustrates, Kamen's generalized allegations of futility have been consistently rejected by the courts as inadequate under Rule 23.1.

Subsection (b) describes the composition of the Fund's ten-member board of directors. Kamen admits that only three of these directors are "interested" under the Act.¹³ The remaining seven members of the board are

¹³ The ICA provides that "No registered investment company shall have a board of directors more than 60 per centum

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presumably "non-interested" directors.¹⁴ The mere fact that the directors receive substantial remuneration for

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of the members of which are persons who are interested persons of such registered company." 15 U.S.C. § 80a-10(a). Section 2(a)(19) of the Act defines an interested person as follows:

(19) "Interested person" of another person means -

(A) when used with respect to an investment company

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company.

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer. . . . *Provided*, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso;

...

15 U.S.C. § 80a-2(a)(19).

¹⁴ Plaintiff also alleges that the president of the Fund is a former president of KFS and a stockholder of KFS's parent,

(Continued on following page)

acting as directors does not, in and of itself, establish that they could not impartially review the merits of Kamen's excessive fee claim. If the fact that a director is paid for his services was sufficient to avoid Rule 23.1, Rule 23.1 would be rendered ineffective.

Furthermore, the fact that these directors assisted KFS in soliciting the allegedly misleading proxy statement does not obviate Kamen's duty to make a demand. The courts have consistently held that "mere approval of challenged conduct is insufficient to render the demand futile." *Lewis v. Anselmi*, 564 F.Supp. 768, 772 (S.D.N.Y.1983); *Atkins v. Tony Lama Co., Inc.*, 624 F.Supp. 250, 255 (S.D.Ind.1985); *Lewis v. Valley*, 476 F.Supp. 62, 64 (S.D.N.Y.1979). See generally *Lewis v. Graves*, 701 F.2d 245, 248-249 (2d Cir.1983), and cases cited therein. As the First Circuit aptly remarked, "It does not follow . . . that a director who merely made an erroneous business judgment in connection with what was plainly a corporate act will 'refuse to do [his] duty in behalf on the corporation if [he] were asked to do so.' Indeed, to excuse demand in these circumstances - majority of the board approval of an allegedly injurious corporate act - would lead to

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Kemper Corporation. The court questions the relevance of this information on the issue of a demand, since plaintiff does not allege that Hawkinson is even a member of the Fund's Board of Directors. The fact that an *officer* of the Fund had a former affiliation with KFS does not have any bearing on the number of "interested" directors because he would only participate in the Board's decision to pursue the action if he were a *director* of the fund.

serious dilution of Rule 23.1" *In re Kauffman Mutual Fund Actions* 479 F.2d at 265 (citation omitted).¹⁵

Subsections (d) and (e) state no facts; they merely reiterate Kamen's conclusion of futility based on her conclusory claim that the entire Board is under the control of KFS and Kemper Corporation, its parent. Rule 23.1 requires Kamen to *particularize* her allegations of control. Kamen's complaint implicitly admits that the Board is composed of at least six disinterested directors. She has not presented the court with any information indicating that these directors are incapable of exercising independent judgment or that the three "interested" directors somehow control the outcome of all the Board's decisions. See *Kauffman*, 479 F.2d at 266. A plaintiff's mere speculation that the majority of the board would refuse to take corporate action is insufficient to satisfy Rule 23.1. *Nussbacher*, 518 F.2d at 879 (7th Cir.1976); *Atkins v. Tony Lama Co., Inc.*, 624 F.Supp. 250, 256 (S.D.Ind.1985).

In subsection (e) Kamen alleges that demand should be excused because the Fund has moved to dismiss the

¹⁵ The demand would not be excused even if Kamen had named the individual directors in her complaint. The courts have uniformly held that, absent allegations of bias or self-interest, naming the individual directors cannot obviate the demand requirement of Rule 23.1. See generally *Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir.1983); *Lewis v. Curtis*, 671 F.2d 779, 785 (3d Cir.), *cert. denied*, 459 U.S. 880, 103 S.Ct. 176, 74 L.Ed.2d 144 (1982); *Lewis v. Sporck*, 612 F.Supp. 1316, 1322 (N.D. Cal.1985); *Kaufman v. Safeguard Scientifics, Inc.*, 587 F.Supp. 486, 489 (E.D.Pa.1984).

complaint on substantive grounds.¹⁶ The futility of a demand should be gauged at the time the suit is commenced. *Grossman v. Johnson*, 674 F.2d 115, 123 (1st Cir.), cert. denied, 459 U.S. 838, 103 S.Ct. 85, 74 L.Ed.2d 80 (1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir.1978), cert. denied, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979); *Shlensky v. Dorsey*, 574 F.2d 131, 142 (3d Cir.1978); *Seidel v. Public Service Co. of New Hampshire*, 616 F.Supp. 1342, 1350 (D.N.H.1985). "It is clear that 'the filing of the complaint cannot be regarded as a demand to sue, for by starting the action [plaintiff has] . . . usurped the field.' " 7C Wright, Miller & Kane, *Federal Practice & Procedure* § 1831, quoting *Lucking v. Delano*, 117 F.2d 159, 160 (6th Cir.1941). The fact that a corporation resists the suit or demands that the requirements of Rule 23.1 be met is insufficient to establish that the board would reject a demand if the plaintiff-shareholder had requested it to act. See *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 527 (S.D.N.Y.1981); *Grossman v. Johnson*, 89 F.R.D. 656, 659 (D. Mass.1981). Kamen thrust the Fund into an adversary role when she instituted this action. She cannot use the fact that the Fund defended itself in this lawsuit to justify her own failure to comply with Rule 23.1 in the first place.

The demand requirement is a necessary prerequisite to all suits under Rule 23.¹⁷ As the court in *Lewis v. Anselmi* noted,

¹⁶ The Fund has joined Kemper in its motion to dismiss Kamen's § 20(a) claim for failure to make a demand and for failure to state a cause of action.

¹⁷ This court echoes the Seventh Circuit's query in *Nussbacher*: "It may be wondered why counsel would not

Rule 23.1 represents a strong statement of public policy which this court is bound to enforce. It has its historical origin in a perceived evil, the maintenance of strike suits by minority shareholders which impede corporate management at great cost and to little purpose except the enrichment of counsel, coupled also with unnecessary interference by outsiders with internal corporate affairs, which should have been administered at least in the first instance by those elected by the shareholders to do so.

564 F.Supp. 768, 772 (S.D.N.Y.1983). The court finds that Kamen's generalized allegations of futility, unsupported by any specific facts, are insufficient to excuse her failure to approach the Fund's Board of Directors before she filed this lawsuit. Accordingly, the court dismisses Kamen's § 20(a) claim for failure to comply with Rule 23.1.

Motion To Strike Jury Demand

The dismissal of Kamen's § 20(a) claim does not affect her § 36(b) claim, which KFS apparently concedes is sufficient for the purposes of Fed.R.Civ.P. 12(b)(6).¹⁸ In addition to the dismissal of the Section 20(a) claim, KFS' motion also seeks to strike Kamen's jury demand on the

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almost routinely take the course of making a formal demand, diligently and in good faith, and in so doing inform the board adequately of the basis of the claim he was asking them to enforce." 518 F.2d at 877.

¹⁸ KFS recently filed a motion for summary judgment on the issue of whether Kamen can fairly and adequately represent the other shareholders in this action.

ground that the Seventh Amendment's right to jury "in actions at law" does not extend to § 36(b) claims, which are essentially equitable in nature.

Section 36(b) of the ICA, 15 U.S.C. § 80a-35(b), creates a cause of action on behalf of a security holder of an investment company to recover excessive fees paid to the investment company's advisor. Subsection (3) of the Act limits this cause of action by providing:

No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and *shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.*

15 U.S.C. § 80a-35(b)(3) (emphasis supplied). The Seventh Circuit has never discussed the right to a jury trial in the context of a Section 36(b) action. To the court's knowledge, only two circuits have addressed the issue, both concluding that a plaintiff in these actions is not entitled to a jury trial on his Section 36(b) claims. *See In re Evangelist*, 760 F.2d 27, 29-30 (1st Cir.1985); *In re Gartenberg*, 636 F.2d 16, 17-18 (2d Cir.1980); *cert. denied*, 451 U.S. 910, 101 S.Ct. 1979, 68 L.Ed.2d 298 (1981). *See also Weissman v. Alliance Capital Management Corp.*, 84 Civ. 8904 slip op. at 5-6 (S.D.N.Y. Nov. 26, 1985) [Available on WESTLAW,

DCT database], *pet. for mandamus denied sub nom. In re Weissman*, 788 F.2d 5 (2d Cir.1986); *Tarlov v. Paine Webber Cashfund, Inc.*, 559 F.Supp. 429, 441 (D.Conn.1983); *Jerozal v. Cash Reserve Management, Inc.*, [1982-83 Transfer Binder] Fed.Sec.L.Rep. (CCH)¶99,019 at 94,827 (S.D.N.Y. 1982); *Markowitz v. Brody*, 90 F.R.D. 542, 547-48 (S.D.N.Y. 1981).

These courts all reason that, since § 36(b) involves a claim for breach of fiduciary duty and limits damages to restitution of excessive fees, the action is essentially in equity and therefore not covered by the Seventh Amendment. *Evangelist, supra*; *Gartenberg, supra*. In the present case, Kamen's Section 36(b) claim is identical to those addressed in the cases listed above. She has not presented the court with any authority rejecting the analysis of the First and Second Circuits on this narrow issue.¹⁹ This

¹⁹ Kamen argues that § 36(b)'s reference to "damages," and her request for "damages" renders her claim an action at law. This argument has been rejected by every court that has considered it. With respect to the fact that the statute uses the word "damges," the *Gartenberg* court held:

[I]t seems likely from the context that Congress was using 'damages' merely as a shorthand for 'recovery of money,' not as a legal term of art. Since . . . not all claims for monetary relief are legal in nature, the use of the term 'damages' is not persuasive in this instance. In particular, given the repeated statement in the legislative history that actions under 36(b) are equitable, to be administered on equitable standards, it would seem impossible to conclude from the use of the word 'damages' that Congress thereby provided for a trial by jury.

Gartenberg v. Merrill Lynch Asset Management, Inc., 487 F.Supp. 999, 1006 (S.D.N.Y.), *mand. denied sub nom. In re Gartenberg*, 636

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court agrees with the controlling weight of authority that Section 36(b) creates restitutionary relief for fiduciary breach, which is traditionally addressed by the courts of equity.²⁰ Accordingly, the court finds that plaintiff has no

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F.2d 16 (2d Cir.1980), *cert. denied*, 451 U.S. 910, 101 S.Ct. 1979, 68 L.Ed.2d 298 (1981). See also *In re Evangelist*, 760 F.2d 27, 30 (1st Cir.1985).

Although the *Evangelist* court was unequivocal in its denial of a right to a jury trial, the *Gartenberg* court qualified its decision in the last paragraph: "Our decision is limited, of course, to the facts of this case. We leave for another day a determination as to the right of a jury trial of a plaintiff making a bona fide claim for damages." *In re Gartenberg*, 636 F.2d at 18. Kamen argues that because her complaint seeks damages, she falls within this *Gartenberg* caveat. The Second Circuit has never explained this final comment to its opinion; however, the court finds that Kamen's Section 36(b) claim is no different than that advanced in *Gartenberg*. The fact that her complaint requests "damages" does not automatically render her claim an action at law. As the *Evangelist* court noted,

[I]n our view, the right to jury trial cannot turn on the simple substitution of a different word. *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 477-78, 82 S.Ct. 894, 899-900, 8 L.Ed.2d 44 (1962) ('the constitutional right to a trial by jury cannot be made to depend on the choice of words used in the pleadings.'). . . . Otherwise, any equitable action for money, say for restitution, could become a legal action by the use of the word 'damages' in place of the word 'restitution.'

760 F.2d at 31. The semantics of Kamen's complaint cannot reign over the substance of her Section 36(b) claim, which is an action seeking restitution for excessive fees paid to KFS.

²⁰ Kamen also argues that Section 44 of the ICA, 15 U.S.C. § 80a-43, refutes KFS' argument regarding the availability of

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right to jury trial for her § 36(b) claims, and grants KFS' motion to strike Kamen's jury demand.

Conclusion

In the present case, although Kamen alleged sufficient facts to state a claim under § 20(a), she failed to comply with Rule 23.1's important demand requirement, and her proffered excuse for this non-compliance is insufficient to satisfy the futility exception to the rule. Accordingly, the court dismisses Kamen's § 20(a) claim for failure to make a demand on the Fund's Board of Directors. In addition, the court finds that Kamen is not entitled to a jury trial on her § 36(b) claim, and grants KFS' motion to strike her jury demand.

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jury trials in § 36(b) suits. Section 44 confers jurisdiction on the federal courts over "all suits in equity and actions at law brought to enforce any liability or duty created by" the ICA, and authorizes the SEC to "intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoin any non-compliance with, Section 36(b) . . ." Kamen maintains that these provisions indicate that actions under § 36(b) can be characterized as a suits at law, thereby entitling her to a jury trial. As KFS correctly notes, however, this language merely permits the SEC to intervene in § 36(b) actions; it does not change the equitable nature of the action or the remedy that the plaintiff seeks. The gist of an action under § 36(b) is a suit for an accounting, and the remedy is limited by statute to restitution of the excessive fees paid. Under the circumstances, this action is properly characterized as one in equity, in which Kamen is not entitled to a jury trial.

District Court Order Dated March 12, 1987
Denying Reconsideration

Jill S. KAMEN, Plaintiff,

v.

KEMPER FINANCIAL SERVICES,
INC., and Cash Equivalent Fund,
Inc., Defendants.

No. 85 C 4587.

United States District Court,
N.D. Illinois, E.D.

ORDER

On February 2, 1987, this court held that the plaintiff, Jill Kamen, could state an implied right of action under § 20 of the Investment Company Act; that her § 20 claim is a derivative claim which must be dismissed for failure to comply with the demand requirement of Rule 23.1; and that she is not entitled to a jury trial on her claims arising under § 36(b) of the Act. In the present motion, Kamen requests the court to reconsider its conclusion with respect to the demand requirement and the right to a jury trial under Section 36(b) of the ICA. For the reasons set forth below, the court adheres to its February 2, 1987 rulings on both these issues, and denies Kamen's motion for reconsideration.

In support of her motion for reconsideration with respect to Rule 23.1's demand requirement, Kamen has filed excerpts from the depositions of six of the independent directors in which these directors expressed their present opinions of the merits of Kamen's suit. According to Kamen, these excerpts establish that the directors

would not have prosecuted this action, and that a demand would have been futile. The court rejects this argument for two reasons. First, the futility of the demand is not gauged by the fact that they would not file the suit, it is gauged by a determination of whether the directors are sufficiently detached and independent that they could exercise sound business judgement in responding to the plaintiff's complaint. Although the deposition transcripts indicate that the directors presently do not agree with Kamen, they do not indicate that the directors would not have thoroughly investigated the complaint to determine whether the corporation should institute action against KFS or attempt to restructure its fee arrangement with KFS. None of the directors testified that they would have ignored Kamen's request if she had presented it to them before filing suit.

Second, as this court held in its February 2, 1987 memorandum opinion and order,

The futility of a demand should be gauged at the time the suit is commenced. *Grossman v. Johnson*, 674 F.2d 115, 123 (1st Cir.), *cert. denied*, 459 U.S. 838, 103 S.Ct. 85 (1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129, 99 S.Ct. 1048 (1979). . . . The fact that a corporation resists the suit or demands that the requirements of Rule 23.1 be met is insufficient to establish that the board would reject a demand if the shareholder had requested it to act.

Memorandum Opinion at 19. (other citations omitted). The futility of the demand should be demonstrated at the time the case was filed because that is the time that the shareholder decided to bypass the board of directors and

file suit on her own. Once a plaintiff has taken the decision away from the directors, one would expect the directors to formulate some views on the propriety of the litigation. However, the mere fact that the directors indicate their disagreement with the lawsuit after it is filed does not indicate that they would not have considered a timely demand. Therefore, the court denies plaintiff's motion for reconsideration with respect to the dismissal for failure to comply with Rule 23.1's demand requirement.

Plaintiff's argument with respect to the jury demand presents the same argument considered and rejected in this court's February 2, 1987 opinion. *See* pp. 20-23. The court denies the motion to reconsider this ruling.

District Court Judgment dated September 1, 1989

JUDGMENT DATED SEPTEMBER 1, 1989
AC 450 (Rev. 5, 85) Judgment in a Civil Case

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
Eastern Division

Jill Kamen

JUDGMENT IN A CIVIL CASE

V.

Kemper Financial Services, Inc.
Cash Equivalent Fund, Inc.

CASE NUMBER: 85 C 4587

— Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

XX Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

that since in our August 3, 1989 order, plaintiff was adjudicated as a non-adequate representative plaintiff cannot proceed individually in this § 36(B) action. For this reason, our August 3, 1989 order is amended by deleting the following sentence: "This cause may proceed, if plaintiff so chooses, as a non-class action." Accordingly, judgment is entered in favor of defendants.

9-1-89

Date

H. STUART CUNNINGHAM

Clerk

Illegible

(By) Deputy Clerk

Supplemental Amended Complaint
UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

<hr/>		X
JILL S. KAMEN,	:	SUPPLEMENTAL
Plaintiff,	:	AMENDED
	:	COMPLAINT
-against-	:	<hr/>
KEMPER FINANCIAL SERVICES,	:	85 C 4587
INC., and CASH EQUIVALENT	:	Judge
FUND, INC.,	:	Nordberg
Defendants.	:	PLAINTIFF
	:	DEMANDS
	:	TRIAL
	:	BY JURY
<hr/>		X

Plaintiff, by her attorneys, alleges as follows, on information and belief, except as to the allegations in paragraph 3, which are alleged on knowledge:

1. This Court has jurisdiction of this action under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43.

2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof.

3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund") and has been a shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund.

4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois 60603. It is the type of investment company commonly referred to as a money market fund.

5 (a). The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have maturities not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately \$4,683,000,000 in its money market portfolio and \$470,000,000 in its government securities portfolio.

(b). As of November 26, 1986 the Fund's total assets consisted of \$5,390,000,000 in its money market portfolio and \$660,000,000 in its government securities portfolio.

6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment adviser, manager, primary administrator and underwriter for the Fund.

7 (a). During all times relevant herein, KFS has received and continues to receive a monthly fee divided into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment management fee at the annual

rate of .22 of 1% of the first \$500,000,000 of the combined average daily net assets of the portfolios KFS manages, .20 of 1% of the next \$500,000,000, .175 of 1% of the next \$1 billion, .16% of the next \$1 billion and .15 of 1% of average daily net assets of such portfolios over \$3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first \$500,000,000 of average daily net assets, .30% of the next \$500,000,000, .275% of the next \$1 billion, .265% of the next \$1 billion, and .25% of average daily net assets over \$3 billion.

(b). Effective November 4, 1986, KFS caused the administration agreement with the Fund to be amended to substantially increase the fees payable by the Fund to KFS. Under the amended agreement, the Fund pays to KFS administration fees at the annual rate of .38%. This increase required a change in the expense limitation which otherwise would have been exceeded by the enormous fee burden imposed upon the Fund.

(c). The administration agreement and its amendment were purportedly adopted pursuant to Rule 12b-1 promulgated by the Securities and Exchange Commission under the Act. Under that Rule payments may be made by an investment company, such as the Fund, only if they are pursuant to a plan primarily intended to result in the sale of shares of such investment company. However, the administration agreement entered into between the Fund and KFS and the amendment thereto encompass payments which are not primarily intended to result in the sale of Fund shares. Indeed, the payments made pursuant to the administration agreement are not based upon sales

of Fund shares, but rather upon the assets previously invested in the Fund by customers of KFS affiliates and other broker-dealers to whom the payments are made. Those payments are made without regard to whether sales are being effected by such entities. They are made primarily to enrich KFS, the KFS affiliates and the broker-dealers and are designed neither to promote the sale of Fund shares nor to benefit the Fund or its shareholders.

8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid KFS nearly \$20,000,000 in fees. Of this amount, \$7,481,000 was paid under the investment management agreement and \$11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year paid \$11,602,000 to such firms. Of that amount, \$2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of \$33,000,000 per year. Under the amended administration agreement, firms affiliated with KFS will receive approximately \$5,750,000 per year at the present size of the Fund.

9. Unlike most other investment companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the

fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that the funds are received.

10. Despite the huge growth in the size of the Fund, the only changes in the fee structure were made on December 1, 1981 and November 4, 1986 when, in spite of the economies of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption and amendment of the administration agreement.

11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to KFS has increased enormously and disproportionately to the services rendered by it.

12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the Fund. The directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager, and underwriter for MM and supplies to MM substantially the same services that it supplies or

causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees.

13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy statement for the annual meeting of shareholders on November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first \$215,000,000 with lesser rates on additional assets." This gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were

substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund, to the damage of the Fund and its shareholders.

14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.

15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefore.

16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the foregoing, KFS has breached its fiduciary duty to the Fund.

17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the following reasons:

(a) With respect to the claims asserted under § 36(b) of the Act, no such demand is required;

(b) The board of directors of the Fund consists of ten members. Of those, three are "interested" as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called "non-interested" directors currently receive aggregate remuneration of approximately \$300,000 a year for serving as directors of the Fund and of all of the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;

(c) The proxy statement referred to in paragraph 13 above stated: "The accompanying proxy is solicited by the Board of Directors of the Fund . . . ", and indeed, the directors did vote, without dissent, to distribute the proxy statement to Fund shareholders. Any suit, such as the instant suit, brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund;

(d) Requiring the plaintiff to make a demand on the Fund or its directors to institute or prosecute this action would be futile. It would be tantamount to asking the directors to sue themselves. Moreover, were the directors to accept such an invitation and institute an action, the prosecution of the action would be in hostile hands inimical to its success;

(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;

(f) In responding to the original complaint, the Fund, both in its answer and motion to dismiss, has sought the dismissal of the complaint on substantive grounds;

(g) Under all of the circumstances present in this case, application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act.

WHEREFORE, plaintiff prays for judgment:

- (1) requiring KFS to pay to the Fund its damages;
- (2) awarding plaintiff the costs and expenses of this action, including reasonable attorneys' fees; and
- (3) awarding plaintiff such other and further relief as the Court may deem just and proper.

Dated: Chicago, Illinois
December __, 1986

JOEL J. SPRAYREGEN
CLIFFORD E. YUKNIS
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By: /s/ Clifford E. Yuknis
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By: /s/ Richard M. Meyer
One Penn Plaza
New York, New York 10119
(212) 594-5300
ATTORNEYS FOR PLAINTIFF

PLAINTIFF'S VERIFICATION

STATE OF NEW YORK)
COUNTY OF NASSAU) SS.:

JILL S. KAMEN, being duly sworn, deposes and says that I am the plaintiff named herein, and that I have read the foregoing Amended Complaint and know the contents thereof, and that the same is true to my own knowledge except as to those matters therein stated to be alleged upon information and belief and as to those matters I believe them to be true.

JILL S. KAMEN

Sworn to before me this
day of December, 1986

NOTARY PUBLIC

Statutes and Rules Involved

Article VI of the Constitution provides:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Section 20(a) of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-20(a), provides:

(a) It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 44 of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-43, provides:

The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders

thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 34, or upon a failure to file a report or other document required to be filed under this title, may be brought in the district where in the defendant is an inhabitant or maintains his principal office or place of business. Any suit, or action to enforce any liability or duty created by, or to enjoin any violation of, this title or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of Title 28, United States Code. No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against the Commission in any court. The Commission may intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoin any noncompliance with, section 36(b) of this title at any stage of such action or suit prior to final judgment therein.

SEC Rules 20a-1(a) and 20a-2(b)(4), 17 CFR §§ 270.20a-1(a) and 270.20a-2(b)(4) provide as follows:

Rule 20a-1. Solicitation of Proxies, Consents and Authorizations.

(a) No person shall solicit or permit the use of his name to solicit any proxy, consent or authorization in respect of any security of which

a registered investment company is the issuer, except upon compliance with Rules 20a-2 and 20a-3 and all rules and regulations adopted pursuant to Section 14(a) of the Securities Exchange Act of 1934 that would be applicable to such solicitation if it were made in respect of a security registered on a national securities exchange. Unless the solicitation is made in respect of a security registered on a national securities exchange, none of the soliciting material need be filed with such exchange.

* * *

Rule 20a-2. Information pertaining to Investment Adviser and Investment Advisory Contracts.

* * *

(b) If action is to be taken with respect to an investment advisory contract, the following information shall be included in the proxy statement:

* * *

(4) If the investment adviser acts as such with respect to any other investment company, identify and state the size of each such other company and state the rate of the investment adviser's compensation.

Rule 23.1 of the Federal Rules of Civil Procedure provides:

Rule 23.1. Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a

right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

